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Taxation of Interest-on-Indebtedness in Corporate Acquisitions: An Analysis of a Congressional Response in Merger Tax Reform

ULYSSES S. CROCKETT, JR.*

I. INTRODUCTION

In an effort to limit the federal tax subsidy for sales of corporate businesses by merger and consolidation, Congress in 1969 enacted a new statute now incorporated into the Internal Revenue Code as section 279. This provision limits the amount of deduction for interest paid on debt securities issued in connection with a corporate acquisition. In 1973 the Department of the Treasury promulgated regulations interpreting the new statute. The purpose of this Article is to determine the present relative impact of the new provision on corporate acquisitions by analyzing the most recent available data compiled by the Federal Trade Commission and by the Securities and Exchange Commission regarding current trends in corporate acquisition activity. The legislative history and operative provisions of section 279 will be discussed in detail in terms of the purpose, scope, and probable effectiveness of the section. A discussion of Treasury Department interpretation of the section will accompany the analysis of Internal Revenue Code provisions which are in some respects seemingly inconsistent with the overall legislative purpose of section 279. Finally, a suggestion is made for alteration of the section to make it more effective in neutralizing the role of tax legislation affecting corporate acquisitions.

II. HISTORICAL PERSPECTIVE

The corporate acquisition movement in the late 1960's generated serious governmental concern.[1] It was estimated that there were

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The author dedicates this article to the late Dean Richard J. Childress of St. Louis University School of Law, whose contribution to excellence in the field of legal education is exceeded only by his commitment to human equality and his outstanding ability to stimulate respect for fairness, public service, creativity, and for scholarship among his colleagues and students.

[1]*See* [1969] FTC, ECONOMIC PAPERS 1966-1969 [hereinafter cited as ECONOMIC PAPERS]; Merger Guidelines of Department of Justice, 1 TRADE REG. REP. (CCH) ¶

4,500 merger announcements in 1968 alone,[2] representing an increase of 300% over the number recorded five years earlier. Similarly, in the first quarter of 1969, there were 1,432 such announcements, a 76% increase over the first quarter of 1968.[3] Commentators and government officials were concerned with the possibility that if this structural transformation of American industry were allowed to continue, the country might risk serious political, economic, and social injury.[4]

A. Economic and Tax Law Effects on Corporate Acquisitions

The federal tax statutory scheme governing corporate acquisitions operated as a subsidy to these transactions.[5] For example, before the enactment of section 279 one method of acquisition utilized by corporations was the purchase of stock in another corporation by transferring debt securities. Section 163 of the Internal Revenue Code permitted the acquiring corporation to deduct all of the interest on the indebtedness, and no other provision limited the deduction. It was also possible for the acquiring corporation to receive a stepped-

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4510, at 6881 (Released May 30, 1968), providing that with respect to vertical mergers (acquisitions into a supplying or into a purchasing market), the Department's enforcement activity "is intended to prevent changes in market structure that are likely to lead over the course of time to significant anticompetitive consequences." *Id.* at 6885. *See also* S. 1167, 93d Cong., 1st Sess. (originally introduced as S. 3832, 92d Cong, 2d Sess. (1972)), 119 CONG. REC. 7320 (1973); *The Industrial Reorganization Act: Hearings on S. 1167 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 93d Cong., 1st Sess. (1973); *Report of The White House Task Force on Antitrust Policy, reprinted in* 2 ANTITRUST L. & ECON. REV. 11-52 (Winter 1968-69); *Tax Reform, 1969: Hearings on the Subject of Tax Reform Before the House Comm. on Ways and Means*, 91st Cong., 1st Sess., pt. 7 *passim* (1969) [hereinafter cited as *Hearings on Tax Reform*].

[2]Wall St. J., Apr. 9, 1969, at 16, col. 1.

[3]*Id.*

[4]*See generally* ECONOMIC PAPERS, *supra* note 1. This work explores the arguments and counterarguments in favor of governmental regulation of industrial concentration. *See also* H. GOLDSCHMID, H. MANN, & J. WESTON, INDUSTRIAL CONCENTRATION: THE NEW LEARNING (1974), a collection of economic papers exploring the relative social and economic effects of industrial concentration. The authors' view is that governmental economic concern with industrial asset and market concentration focuses primarily on the increased political and market manipulation power attendant to concentrations of private wealth. *See also* Burck, *The Merger Movement Rides High*, FORTUNE, February 1969, at 79 [hereinafter cited as Burck].

[5]Bittker, *Proposed legislative restrictions on acquisitions of stock by conglomerate corporations*, 30 J. TAX. 354 (1969) [hereinafter cited as Bittker]; Cohen, *Conglomerate Mergers and Taxation*, 55 A.B.A.J. 40 (1969); Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254 (1957) [hereinafter cited as Hellerstein]; Sax, *The Conglomerate and Tax Reform: A Brief Review*, 25 TAX L. REV. 235 (1970) [hereinafter cited as Sax]; Thrower, *Conglomerates—Some Tax Problems*, 25 BUS. LAW. 641 (1970) [hereinafter cited as Thrower]; Crockett, *Federal Taxation of Corporate Unifications: A Review of Legislative Policy*, 15 DUQ. L. REV. 1 (1976).

up basis in the event of liquidation of the acquired company.[6] If the acquiring corporation and the acquired corporation filed consolidated returns,[7] intercorporate dividends might not be taxed.[8] This type of transaction produced such a significant tax advantage that it might be described as a joint venture between the government and the acquiring corporation.

The acquired corporation and its stockholders also received tax advantages. If the acquired corporation received debt securities payable in installments, it could, under pre-1969 law, elect to defer the reporting of gain under the installment sales provisions of the Code.[9] In some instances, this period ranged up to twenty years. The resulting deferral of the gain until either ultimate payment of the debt or sale to a third person[10] had the effect of allowing many corporate acquisitions to enjoy a federal government subsidy similar to that accorded tax-free reorganizations.[11] Shareholders of the acquired corporation benefited from tender offers far above the market price, affording them capital gains taxed at preferential rates.[12]

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[6]I.R.C. §§ 332, 334, 453. *See* Appert, *Installment Reporting As A Substitute For A Tax-Free Reorganization*, 22 TAX LAW. 137 (1968) [hereinafter cited as Appert]; *see also* Silverstein, *Impact Of The Acquisition Indebtedness Provisions Of The Tax Reform Act Of 1969 On Corporate Mergers*, 44 ST. JOHNS L. REV. 353, 367 (1970) [hereinafter cited as Silverstein].

[7]*See* I.R.C. §§ 1501-05.

[8]*Id.* § 243.

[9]*Id.* § 453.

[10]*See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 14.57 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE]; Appert, *supra* note 6.

[11]*See* I.R.C. § 368 and cross-reference provisions; *see also* Sandberg, *The Income Tax Subsidy To "Reorganizations,"* 38 COLUM. L. REV. 98 (1938) [hereinafter cited as Sandberg].

In addition to extending the net operating loss carryover period and restricting, somewhat, the percentage ownership requirements for qualification, section 806(e) of the Tax Reform Act of 1976 contains another significant amendment. Specifically, section 806(e) appears to eliminate the requirement of continuation of substantially the same business of the acquired entity by the acquiring entity, a provision formerly contained in section 382(a)(1)(C). Although it was probably legislative oversight, there appears to be no 1976 Act change in section 381(a)(2) which does not list reorganizations described in subparagraph (B) of section 368(a)(1); yet section 382(b)(1) of the 1976 amended Code specifically lists reorganizations described in subparagraph (B) of section 368(a)(1) as part of the group of reorganizations for which loss carryovers will be allowed. See Tax Reform Act of 1976, § 806(e), I.R.C. § 382. It thus appears that after a valiant struggle, the Libson Shops doctrine shall not be alive even in spirit. *See* Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957); *cf.* TIR 773, ¶ 55,063 P-H Fed. 1965 and Rev. Rul. 58-603, 1958-2 C.B. 147.

[12]I.R.C. §§ 1221-22, 1202.

B. General Anatomy of a Merger Prior to 1969

Most mergers in the recent past had similar characteristics. One was the use of so-called "funny-money" — that is, an exchange of a package of securities including debentures for stock of the target corporation to finance the acquisition.[13] During the years 1967 and 1968, three of the eighteen largest acquisitions, involving assets of $2 billion, included convertible debentures.[14] The use of this type of security package was quite widespread. Promoters would make a public offering of convertible debentures and then use the resulting revenue to finance the acquisition of stock of the selling corporation. The use of "funny-money" led to a trend away from the transfer of acquiring company stock in effectuating a merger.[15] In 1966

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[13]Securities and Exchange Commissioner Budge noted that a typical exchange offer might consist of a proposal to issue a package of securities consisting of:

(1) Forty-five dollar principal amount of subordinated debentures bearing interest at a specified rate.

(2) Three-fifths of one share of preferred stock, and

(3) Three-tenths of a warrant, expiring in five years, to purchase one share of common stock at a specified price, all in exchange for two shares of common stock of a specified issuer.

Chairman Budge indicated that it may be difficult for a shareholder to evaluate the package because of the difficulty in valuing subordinated debt or preferred stock for which there is no market and for which no existing issue can be used for comparison. *Hearings on Tax Reform*, *supra* note 1, pt. 7, at 2368 (statement of Hamer Budge, Chairman, SEC).

[14]ECONOMIC PAPERS, *supra* note 1, at 260.

[15]*Hearings on Tax Reform*, *supra* note 1, pt. 7, at 2366 (Statement of Hamer Budge, Chairman, SEC). Commissioner Budge also noted that in the four years prior to 1969, the basic reasons for combinations and mergers increasingly seemed to be essentially financial. "[C]ompanies are buying other companies or merging with other companies because there are substantial immediate financial advantages to the surviving company in terms of increases in per-share earnings, and in terms of the liquid assets which can be obtained by acquiring other companies." *Id.* at 2367.

In his responses to queries by Representative Byrnes, Commissioner Budge noted that the use of convertible debentures was akin to the use of stock.

> MR. BYRNES. In your experience, and from what you have seen of these operations, is there any question in your mind as to whether they [acquiring corporations] ever intend to pay cash? In redemption of the debenture, don't they anticipate that it is going to be converted into stock?
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> MR. BUDGE. Well, we see two movements in this area. . . .
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> . . . .
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> MR. BYRNES. But don't these proposals contemplate that when the stock exceeds the conversion price then they will then be called and the bondholder will be required to convert it into stock?
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> MR. BUDGE. I would guess that certainly in a great many instances it would be hoped that that would be the result.
>
> . . . .
>
> MR. BYRNES. I just have a feeling that that is the underlying rationale; that this would be, large part, a more or less a postponed sale of stock, in the

acquiring company stock was used in 90% of the tender offers filed with the Securities and Exchange Commission, but in 1968 the corresponding figure was only 40%.[16] In 1966 there were three public issues of debt securities offered to acquire stock in the amount of $47.8 million, but in 1968 there were thirty-one such issues for $4.4 billion.[17] Furthermore, there were fifty-four cash tender offers for stock registered with the Securities and Exchange Commission between July 29, 1968 and February 28, 1969. Approximately $1.135 billion of the cash tender offers were financed by bank loans and $97 million were financed by prior sales of securities.[18]

Mergers accomplished through the use of debt securities at times resulted in a corporate financial structure heavily burdened with debt. Arguably the use of debt securities is not improper so long as the acquiring corporation is conservatively managed with ample cash resources or low debt-equity ratios. However, this is not always the case.[19] Generally a three-to-one ratio of debt to equity has been considered proper;[20] however, many of the acquiring companies did not have a ratio this low. In a 1967 survey of twenty-five acquiring companies, the median debt was 60% of assets, or a five-to-three debt-equity ratio.[21]

Another typical characteristic of these mergers was the tendency

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interim they would be using the interest payment as a deduction, rather than paying tax on the dividend from the current issue of stock.

MR. BUDGE. I think that is correct.

MR. BYRNES. So they are really whipsawing when they call something a debt obligation that they never intended to be a debt obligation; rather, it is going to be converted into stock.

MR. BUDGE. I am sure that in a great many cases that would be the hope. It is also hoped that the price of common stock will go up.

MR. BYRNES. Once the stock price gets higher than the conversion price the corporation calls in the debenture and forces the bondholders to take the stock. This, then, is nothing other than a stock operation under the guise of a debt transaction to avoid tax liability.

Id. at 2371-72.

[16]*Id.* at 2366. *See also* Sax, *supra* note 5, at 248, for discussion of tax reform generally relative to conglomerate industry structure.

[17]*Hearings on Tax Reform*, *supra* note 1, at 2369.

[18]*Id.* at 2366.

[19]The New York Stock Exchange has delisted some securities because of excessive debt structures. N.Y. Times, Apr. 18, 1969, at 61, col. 5.

[20]*See* Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971). *Compare* the two-to-one ratio test of section 279(b)(4)(a) *with* the five-to-one ratio test accepted in the international finance subsidiary area illustrated in Rev. Rul. 69-377, 1969-2 C.B. 231 *and* BITTKER & EUSTICE, *supra* note 10, at 4-19.

[21]*Hearings on Tax Reform*, *supra* note 1, pt. 7, at 2379 (SEC supplementary financial data).

to undergo a "conglomerate"[22] rather than a horizontal[23] or vertical[24] merger. A conglomerate company is usually a group of unrelated businesses, commonly owned, which may or may not be centrally managed.[25] A horizontal merger is one in which a company takes over a competitor, while a vertical merger is one in which a company takes over a supplier or distributor.[26] Prior to the 1950 amendment to the Clayton Act, existing antitrust laws were primarily concerned with horizontal or vertical mergers,[27] and the agencies charged with regulating these transactions were the Federal Trade Commission and the Antitrust Division of the Department of Justice.[28] When conglomerate mergers became popular, governmental agencies were ill-equipped or ill-disposed to limit them.[29] The antitrust agencies were able to show sufficient anti-competitive effects within specific,

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[22]Conglomerate mergers may be of three types: (a) geographic market extension, (b) product market extension, and (c) pure or "other." For further description of these types of conglomerate merger, *see* ECONOMIC PAPERS, *supra* note 1, at 250. *See also* E. SINGER, ANTITRUST ECONOMICS 259-69 (1968) [hereinafter cited as SINGER].

[23]*See* ECONOMIC PAPERS, *supra* note 1, at 250.

[24]*Id.*

[25]For a thoughtful analysis of the economic rationale for and effect of conglomerate mergers, see Edwards, *Conglomerate Bigness as a Source of Power*, in BUSINESS CONCENTRATION AND PRICE POLICY 366; SINGER, *supra* note 22, at 260.

[26]ECONOMIC PAPERS, *supra* note 1, at 250.

[27]Clayton Act, ch. 323, § 7, 38 Stat. 730 (1914) (current version at 15 U.S.C. § 18 (1970)).

[28]The Justice Department and the FTC have promulgated guidelines indicating those mergers which are to be subject to antitrust law enforcement. *See* Merger Guidelines of Department of Justice, 1 TRADE REG. REP. (CCH) ¶4510, at 6881 (released May 30, 1968); *see also* Textile Mill Products Industry, *id.* ¶ 4535, at 6916 (FTC Release rescinded May 15, 1975); Grocery Products Manufacturing — Product Extension Mergers, *id.* ¶ 4530, at 6908 (FTC Release, May 15, 1968); Food Distribution Industries, *id.* ¶ 4525 (FTC Release, Jan. 17, 1967); Cement Industry — Vertical Mergers, *id.* ¶ 4520, at 6901 (FTC Release, Jan. 17, 1967).

[29]*See e.g.*, Sax, *supra* note 5, at 238-39. Prior to the enactment of section 279, the Supreme Court found only a few conglomerate mergers violative of the antitrust laws, in cases in which significant anticompetitive efforts existed in narrowly defined markets. *See* FTC v. Procter & Gamble Co., 386 U.S. 568 (1967); United States v. Philadelphia Nat'l Bank, 374 U.S. 321 (1963); Brown Shoe Co. v. United States, 370 U.S. 294 (1962), *discussed in* Blake & Jones, *Toward a Three-Dimensional Antitrust Policy*, 65 COLUM. L. REV. 422 (1965); Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313 (1965).

Before the 1960's only one conglomerate merger case, involving the Ling-Tempco-Vought, Inc. acquisition of a controlling interest in Jones & Laughlin Steel Corp., was really resolved, and that was settled by consent decree. ANTITRUST & TRADE REG. REP. (BNA) No. 467, A-1,-2 (June 23, 1970). The decree allowed LTV to retain its interest in Jones & Laughlin provided that LTV divested its interest in Braniff Airways, Inc. and in Okonite-Callender Cable Co. Hence, only partial divestiture was achieved.

relevant markets to prevent only a few conglomerate mergers.[30] These few challenges failed to stem the growing merger movement.

The third characteristic of conglomerate mergers during the late 1960's was the frequency of takeovers. The acquiring corporation would offer substantial prices for stock in the target corporation. The target company management could attempt to prevent a takeover by raising funds to acquire its own outstanding stock, purchasing the stock, and thus counteracting the move of the acquiring corporation. Many times this procedure was unsuccessful, either because the target company acted too late or because the funds raised were insufficient to obtain the controlling stock necessary to prevent takeover. Other target corporations, with managements eager to retain their positions, would consummate hasty and often ill-advised mergers just to save the managers' "skins." Usually an agreement would be made with the acquiring corporation to allow managers of the target corporation to retain their positions. At times, resistance by the target corporation led to a downward trend in the price of the stock and to subsequent financial ruin. Many felt that this merger warfare between corporations was not only disruptive to the target corporations, but potentially harmful to the economy as a whole.[31] By contrast, others felt that conglomerate organization maximizes efficiency and productivity by funneling capital to enterprises which, in turn, can use the capital most profitably.[32] Studies indicate, however, that most target corporations were financially healthy and growing firms[33] whose profits, when added to balance sheets of acquiring firms, generally made the acquiring firms look more profitable than before the merger. Another argument advanced by those favoring conglomerate mergers is that the conglomerate revitalizes complacent enterprises that have grown fat and sluggish in sheltered corners of the marketplace.[34] In addition, some take the position that conglomerate organization means a freer, more flexible, and, on the whole, a more competitive economy.[35]

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[30]For a collection of cases in this area, see J. NARVER, CONGLOMERATE MERGERS AND MARKET COMPETITION (1967).

[31]ECONOMIC PAPERS, *supra* note 1, at 266-67. *See also* [1969] ECON. REP. OF THE PRES. 108.

[32]Burck, *supra* note 4, at 80.

[33]ECONOMIC PAPERS, *supra* note 1, at 247 n.4. For example, for the period 1948 through 1968, had the 1,202 large companies not been acquired, there would have been at least 50% more companies with assets in excess of $10 million operating in 1968. Moreover, only 6 of the 192 "large" companies acquired in 1968 had losses in 1967. *Id.*

[34]*See* Burck, *supra* note 4.

[35]*Id. But see* ECONOMIC PAPERS, *supra* note 1, at 273-86, where it is observed: "The best available evidence argues that most large conglomerate mergers have not occurred for [reasons of managerial efficiency, creativity, research and innovation], or if they have, that they have not achieved their goals." *Id.* at 285.

The fourth characteristic of the merger movement was the "bootstrapping" feature of acquisitions. If the target firm had ample cash reserves or a relatively low debt-equity ratio, the acquiring corporation could literally finance the takeover by exchanging debt securities in its own corporation for equity in the target firm. This method of acquisition increases the acquiring firm's "leverage"[36] by increasing its own debt-equity ratio. The acquiring corporation's new management with its "high flying" standards would constantly seek companies with which to merge, allowing it to "leverage up." This not only gave the acquiring firm greater leverage, but also allowed it larger tax deductions for interest payments.

Richard Cheney, a public relations consultant who counseled corporations on acquisition programs, illustrated debt-equity switching in a speech:

> A [firm] using subordinated debentures, convertible securities and/or warrants can afford to pay a big premium for an old line company with no debt. To get the wherewithal for his offer, all he needs is his own printing press to print the securities he is using to make his tender. And he can afford to offer a big increase in investment income to the stockholders of the target because he has the federal tax laws going for him.
>
> He will leap at the chance to offer a $50 debenture paying $3 interest for a stock selling at $40 and paying a $2 dividend. Why not? He actually makes money in the deal. For every share of stock he gets through his tender, he makes $2 in dividends. On this he pays only about 15 cents per share in taxes because the dividend is an intracompany dividend and the Treasury excludes 85 percent of such dividends from taxation. At the same time, the $3 in interest he pays out is a cost of doing business for tax purposes. Each $3 he pays out cost him only $1.50. So he's taking in $1.85 in dividends after taxes and paying out $1.50 after taxes. Thus for every share he gets in his tender he makes 35 cents. He can afford to run his printing presses overtime creating funny money by the truckload.[37]

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[36]Basically, "leverage" is the amount of borrowed funds used in making an investment. To the extent the cost of borrowed funds is less than the amount of return on the borrowed funds invested, there is an incentive for investors to use debt in making investments. Accordingly, the allowance of a tax deduction for the interest cost of borrowed funds effectively reduces the amount invested. For other examples and discussion of the leverage concept, see 1 S. SURREY, W. WARREN, P. MCDANIEL, & H. AULT, FEDERAL INCOME TAXATION 413-21, 416 n.18 (1972) [hereinafter cited as SURREY, ET AL.].

[37]Address by Richard Cheney, Senior Vice-President of Hill and Knowlton, Inc., before the Ohio State Bar Association (Nov. 7, 1968), *reprinted in part in Hearings on Tax Reform, supra* note 1, at 2419.

Mr. Cheney's example is comparable to facts which were the subject of a 1968 revenue ruling on an interest deduction for the issuance of registered subordinated debentures.[38]

III. The Genesis of Section 279: H.R. 7489 and Sections 411-414 of H.R. 13270

A. General Legislative Rationale

In the late 1960's an effort was made to place a check on the use of debt in corporate acquisitions. In 1969 Congressman Wilbur Mills, Chairman of the House Ways and Means Committee, issued a press release expressing consternation with the "increasing trend in recent months towards conglomerate mergers."[39] Mr. Mills questioned whether the welfare of the shareholders or the economy was served by permitting conglomerate mergers to continue at the then-current level. He urged companies to go slow in conglomerate mergers if they were depending upon any of the tax provisions for success of their mergers.[40] Later in 1969 Mr. Mills proposed H.R. 7489, which would have disallowed the deduction for interest paid or accrued by a corporation with respect to debt issued as consideration in connection with a plan of acquisition of stock of another corporation.[41] H.R. 7489 also would have denied use of the installment method of reporting gain[42] to sellers of shares in exchange for corporate debt issued with interest coupons or in registered form. Testimony from the Securities and Exchange Commission, the Federal Trade Commis-

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[38]*See* Rev. Rul. 68-54, 1968-1 C.B. 69; I.R.C. § 163. Generally, the issuance of debt constitutes an event for the recognition of gain or loss. *See* LeTulle v. Scofield, 308 U.S. 415, *rehearing denied*, 309 U.S. 694 (1940), where the taxpayer's wholly-owned corporation transferred all its assets to another corporation for cash and 10-year bonds. The Court ruled that the transfer amounted to a sale upon which gain or loss must be recognized and that the retention of a proprietary interest was not sufficient to bring the transaction within the nonrecognition provisions of the Code (the predecessors of current sections 361 and 368(a)(1)). *See also* I.R.C. §§ 354(a)(2), 354(b), 355(a)(3), 356(a)(2).

A valid election serves to defer the recognition of gain. *Id.* § 453. In addition, if the holder of the debt instrument were elderly and the maturity date (or the second payment date) were set sufficiently into the future, the holder's death might occur before any tax became due. While income in respect of a decedent would arise at the holder's death, the income tax deduction available to the estate could approach, equal, or exceed the benefits to be derived from date-of-death basis available to the seller had the initial shares been held for exchange in a non-taxable transaction. *See id.* § 691(a)(4); Treas. Reg. § 1.691(a)-5 (1965); Rev. Rul. 55-481, 1955-2 C.B. 279.

[39]*House Committee on Ways and Means Release*, 1969, P-H ¶ 59, 501.3 (Feb. 10, 1969). *See also* Silverstein, *supra* note 6, at 353 n.2.

[40]*House Committee on Ways and Means Release*, 1969 P-H ¶ 59, 501.3 (Feb. 10, 1969).

[41]H.R. 7489, 91st Cong., 1st Sess., 115 Cong. Rec. 4210 (1969).

[42]*But see* I.R.C. § 453(b).

sion, and the Justice Department supported the concept of the legislation.[43] Some members of the business community concerned with "takeovers" also supported the legislation. Opponents pointed out that the proposal would restrict the ability of small companies without access to the stock market to issue debt.[44]

The disallowance of the interest deduction was arguably a departure from the theory of prior law, in which interest deductions had been disallowed only in those situations in which the deduction either was a "sham"[45] or was taken to avoid taxation.[46] In the "sham" cases, the courts have interpreted the term "interest" according to its common law meaning, "compensation allowed by law or fixed by the parties for the use or forbearance of money or as damages for its detention."[47] Since no valid indebtedness exists in the "sham" cases, the payment is not for the use or forbearance of money and cannot be deducted as interest.[48] In other cases, in which the debt was valid but was created for the sole purpose of avoiding federal taxes, interest deductions have been disallowed on the ground that Congress never intended section 163 to be utilized in transactions impelled solely for

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[43] *Hearings on Tax Reform, supra* note 1, pt. 7, at 2363-82, 2386-448.

[44] *Id.*

[45] For a discussion of the most authoritative judicial commentary justifying the elevation of substance over form in tax transactions, *see* Bazley v. Commissioner, 331 U.S. 737 (1947); Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465 (1935).

[46] I.R.C. §§ 269, 482.

[47] Anna Foster, 45 B.T.A. 126 (1941), *aff'd*, 131 F.2d 405 (5th Cir. 1942). A legatee was to receive $75,000 income for life from trust assets consisting of stocks and bonds, which, because of financial conditions, could only be converted to cash at a large loss. The legatee and administrator agreed, therefore, to postpone distribution until the market became more favorable. Four years after the time for initial distribution, legatee received approximately $10,000 designated as "interest" which was not included in the gross income of the legatee. Citing Fall River Electric Light Co., 23 B.T.A. 168, 171 (1931), the Board ruled that interest is generally defined to be "compensation allowed by law or fixed by the parties, for the use or forbearance of money or as damages for its detention." 45 B.T.A. at 129. Thus, even though the sum in question was paid for the *detention of money* rather than for use of money, it was paid as *interest or in lieu of the income* to which legatee would have been entitled under the trust. Accordingly, the amounts were properly includible in the gross income of the legatee. For a more complete discussion of the types of transactions generating interest income, see 1 SURREY, ET AL., *supra* note 36, at 556-68.

[48] In Goodstein v. Commissioner, 267 F.2d 127 (1st Cir. 1959), the cash method accounting taxpayer borrowed money for the purchase of treasury notes to be held as security for the loan. When the taxpayer issued checks for the payment of interest on the loan, the lender would issue another check for the same amount and receive in return the taxpayer's promissory note for the amount of interest due. The taxpayer then would deduct the amount of interest allegedly paid on his tax return for the year. The court found that the transaction was without substance and disallowed the interest deduction on the theory that there was no real liability on the part of the taxpayer.

tax avoidance.[49] Similarly, section 265(2) of the Code, which disallows deductions for interest on debt used to purchase or carry tax-exempt securities, was enacted to prevent tax avoidance. However, the fact that a person obtained a substantial economic advantage through interest deduction was not sufficient to cause disallowance.[50]

The disallowance of interest deduction in H.R. 7489 was one approach to the conglomerate merger problem. The proposal, however, applied only to acquisitions of stock, exempting acquisitions of assets.[51] The disallowance could occur with respect to any kind of indebtedness and would not depend on the obligation's being convertible, subordinated, or otherwise suggestive of an equity interest. There was no essential reason for preserving this distinction other than the fact that an acquisition of assets requires the imprimatur of the acquired corporation's existing management.[52] If the management consented to a sale of assets, H.R. 7489 imposed no restriction on the acquiring corporation's use of borrowed funds or other evidence of indebtedness as consideration.[53] If consent were withheld, however, and the acquiring corporation appealed to the target company's shareholders over the heads of its management, the proposed legislation's disallowance of the interest deduction would have come into play.[54]

Under the proposed bill the deduction for interest on indebtedness incurred by a corporation acquiring stock in another was limited only if more than 35% of the consideration for the stock consisted of evidences of indebtedness of the acquiring corporation or of other

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[49]*See* Knetsch v. United States, 364 U.S. 361 (1960). A taxpayer purchased an annuity contract and each year would borrow its maximum cash value, prepay interest, and execute a promissory note for the alleged loan, thereby preventing the annuity from ever building any value. In disallowing the interest deductions the Court ruled that the arrangement had no economic significance other than the generation of tax deductions contrary to the intent of Congress. *See also* Rothschild v. United States, 407 F.2d 404 (Ct. Cl. 1969), in which the court denied the interest deduction of the taxpayer because the transaction, though more than a sham, had no *independent economic significance.*

[50]In Commissioner v. Brown, 380 U.S. 563 (1965), a lumber company sold its assets, valued at approximately $1 million, to a tax exempt organization for approximately $1.3 million. The remaining $300,000 was considered the equivalent of interest. The Supreme Court, in a questionable opinion, upheld this characterization on the theory that the sale price roughly approximated the fair market value of the assets within a "reasonable range." Mr. Justice Harlan, however, observed that the charity obviously traded on its tax exemption. *Id.* at 580 (concurring opinion).

[51]H.R. 7489, 91st Cong., 1st Sess., 115 CONG. REC. 4210 (1969).

[52]*See* Bittker, *supra* note 5.

[53]*See* H.R. 7489, 91st Cong., 1st Sess., 115 CONG. REC. 4210 (1969).

[54]*Id.*

property attributable to borrowing.[55] If such conditions were met, the bill required reduction of the acquiring corporation's deduction for interest to an amount obtained by multiplying the amount of such interest by a fraction, the numerator being 35% and the denominator being the percentage of the consideration obtained by proscribed borrowing.

B. Inadequacies of H.R. 7489

Some aspects of H.R. 7489 were cause for concern. Although one aim of the bill was the curtailment of abuses of the merger tax subsidies, the nature of the acquiring corporation's business or the amount of stock acquired was not taken into account. Similarly, the proposed bill would not have applied if the borrowed funds or debt securities were not used to acquire stock or if such securities constituted no more than 35% of the consideration. This 35% provision would have applied equally to large and small business acquisitions. Thus, the bill required the denial of an interest deduction if a small acquisition were accomplished by mortgaging the assets of the business to be acquired in order to pay cash to the seller.

The bill's application solely to stock acquisitions was arguably less than logical from a policy standpoint. Also a tracing problem may exist in determining whether the consideration used for acquisition is debt or other property attributable to borrowing.[56] For example, if a corporate taxpayer invests borrowed funds in equipment that is not essential to its current operations, thereby allowing unexpended cash on hand to be used for a stock acquisition, it might be difficult to attribute the consideration for the acquisition to borrowing.

The bill did not require that controlling interest in the acquired corporation be obtained before denial of the deduction. Thus, the bill would have resulted in interest deduction denial to alleged legitimate transactions not associated with tax abuses or the conglomerate merger problem. H.R. 7489 also failed to distinguish between the

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[55]*See* Sax, *supra* note 5, at 253-54, for a discussion of practical considerations involved in the 35% consideration test.

[56]*See, e.g.*, Leslie v. Commissioner, 413 F.2d 636 (2d Cir. 1969), in which the court disallowed a portion of an interest deduction where the taxpayer-partner in an investment house purchased and sold tax-exempt securities as part of its business, while at the same time borrowing to finance customers' purchases of securities in margin accounts. Although the tax-exempt securities were not used to secure the borrowings and the borrowed money was not "directly traceable" to the continued holding of the tax-exempt securities, the borrowing was related to the brokerage house's entire business activity which included the holding of tax-exempt securities. *See also* Wynn v. United States, 411 F.2d 614 (3d Cir. 1969).

various purposes for which corporations may seek to gain control of others. For example, the acquiring corporation may seek control of other companies solely to avail itself of tax advantages other than interest deductions, such as the tax-free liquidation of a subsidiary corporation under section 332,[57] qualification for section 1563 controlled-group surtax exemptions,[58] and section 1504 affiliated-group status for section 243 tax-free intercorporate dividends.[59]

As a last major problem, the proposed bill contained no provision to avoid "creeping" acquisition, the acquiring of a target corporation through piecemeal acquisition of stock or assets.

C. H.R. 13270: The Legislative Alternative to H.R. 7489

Sections 411 through 415 of H.R. 13270, which added sections 279 and 385 to the Code,[60] were passed by the House of Representatives in lieu of H.R. 7489. While H.R. 7489 was, in some respects, too broad, its successor is arguably too narrow in that it is directed at a specific method of effecting corporate acquisitions. Instead of being directed at tax abuse generally, the section seems specifically aimed at removing a significant tax benefit, irrespective of legitimacy, from corporate acquisitions. Section 411 through 414 of H.R. 13270 contain four basic provisions affecting the use of convertible debentures in the "conglomerate merger" area.[61] By its terms, section 279 is primarily directed at limiting the use of subordinated convertible debentures in corporate acquisitions and the corresponding deduction of interest payments from gross income of the acquiring corporation. The government subsidy under prior law included (a) the interest-free loan of deferred tax on gain permitted to be reported in installments by the selling shareholder, (b) taxation of gain to the selling shareholder at capital gains rates, and (c) the allowed deduction from gross income of interest payments by the issuing corporation. The convertibility feature of such securities gives them a quality similar to equity on which dividend payments would not be deductible by the issuing corporation. Another advantage, under

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[57]Under I.R.C. § 332, the parent corporation control requirement is 80% of all voting stock and 80% of all other classes of stock in the distributing corporation.

[58]I.R.C. § 1563 requires corporate-parent control over 80% of all voting stock or control over 80% of all classes of stock for a subsidiary corporation to have status as a member of a controlled group.

[59]Under I.R.C. § 1504, corporations whose common parent controls 80% of the voting stock and 80% of each class of nonvoting stock are members of an affiliated group and the intercorporate dividends received are allowed the deduction provided for in section 243.

[60]H.R. 13270, 91st Cong., 1st Sess. §§ 411, 415 (1969), I.R.C. §§ 279, 385; *see also* Thrower, *supra* note 5.

[61]*See* text accompanying notes 74-145 *infra.*

prior law, to a corporate issuance of convertible debt instead of stock is that dividend payments reduce earnings, which amounts, if reinvested, produce revenues at the corporate internal rate of investment return; the deductibility of interest payments on debt provides an alternative means of financing where earnings are insufficient for dividend payments or for the investment required in the desired project, and where further equity dilution is undesirable. Moreover, assuming an issuance of either debt or stock in equal amounts, in order for the net gain to the corporation from stock issuance to exceed the net gain from issuance of debt, the rate of dividend payments on the stock issued must be less than one-half the interest rate payable on an equal amount of debt issued, given a corporate tax rate of approximately 50%. A corporation would not rationally issue debt paying a rate of interest higher than its capitalization rate. Thus, for a stock issuance to be attractive to either new or old shareholders, the dividend rate should be higher than the company's capitalization rate.[62] Put formalistically: Let

G_{NE} = corporate net gain from issuance of stock;

G_{ND} = corporate net gain from issuance of an equal amount of debt securities.

The relationship of the algebraic sum of gain from each type of financing can be represented by the following equation:[63]

$$G_{NE} - G_{ND} = r_i (1 - T^c) - r_d$$

Assuming a corporate tax rate of 50%,

$$G_{NE} - G_{ND} = \tfrac{1}{2} r_i - r_d$$

where:

r_i = interest rate payable on debt issued;

r_d = dividend rate on stock issued;

T^c = corporate tax rate of 50%.

Accordingly, for G_{NE} to exceed G_{ND}, $\frac{1}{2}r_i$ must exceed r_d, that is, the rate of interest payable on debt must be less than one-half the dividend rate payable on an equal amount of stock issued.

The interest deduction subsidy illustrated in the above example is not meaningfully constrained under section 279 since up to $5 million worth of interest may be deducted without penalty.[64]

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[62]Of course, a company could refrain from paying dividends altogether and reinvest these earnings at its higher internal investment rate of return. Such a policy would, however, adversely affect the price of its outstanding stock and would raise the company's overall cost of capital. For a thoughtful discussion of market reactions to alternative methods of corporate finance, see, Alberts, *The Profitability of Growth by Merger*, in THE CORPORATE MERGER 235-87 (W. Alberts & J. Segall ed. 1966).

[63]The derivation of this equation appears in Appendix B. *See also* Statement of Hon. Hamer H. Budge, former chairman of the Securities and Exchange Commission. *Hearings on Tax Reform*, *supra* note 1, at 2363.

[64]*See* notes 74-78 *infra* and accompanying text.

The debt-equity ratio test of section 279 is arguably designed to prevent corporations from assuming too high a percentage of debt obligation which assumption might cause significant losses to investors in the event of recession, high inflation, or insolvency. Another ostensible purpose of section 279 is to limit the amount of equity loss to investors who receive debt in exchange for equity in many acquisition transactions. Since acquisition of corporate assets directly has practically the same effect as acquiring the underlying corporate stock, Congress presumably felt that, as a matter of logical consistency, section 279 should also apply to debt-financed asset acquisitions.

While the House of Representatives was conducting hearings on H.R. 13270, the Treasury Department submitted proposals dealing with the use of debt in connection with corporate acquisitions.[65] Assistant Secretary for Tax Policy Edwin S. Cohen observed that H.R. 7489 had not adequately addressed the basic question existing under our tax structure whereby an interest deduction is properly disallowed only if the underlying obligation constitutes equity rather than debt. Accordingly, the Treasury proposed that the Department develop rules or regulations to aid in distinguishing debt from equity and disallow the interest deduction where the interest payments represent, in substance, a return on equity.[66] The Senate Committee on Finance heeded the proposal and recommended that H.R. 13270 be amended to incorporate the Department's suggestion.[67] This recommendation eventually became section 385 of the Code. The Treasury proposed that such rules apply whether the instrument originates as the result of an acquisition, a recapitalization, or in any other manner, and whether the company is closely held or publicly held.

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[65]*See Hearings on Tax Reform, supra* note 1, pt. 14, at 5380-84.

[66]*Id.* at 5511-12 (statement of Hon. Edwin S. Cohen).

[67]S. REP. No. 552, 91st Cong., 1st Sess., *reprinted in* [1969] U.C. CODE CONG. & AD. NEWS 2170 [hereinafter cited as S. REP. NO. 552]. Section 385(b) of the Code provides the following tests for distinguishing between debt and equity:

> (1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest;
>
> (2) whether there is subordination to, or preference over, any indebtedness of the corporation;
>
> (3) the ratio of debt to equity of the corporation;
>
> (4) whether there is convertibility into the stock of the corporation; and
>
> (5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

To date the Treasury Department has not issued regulations pursuant to the statutory provision. Thus, case law consistent with the statutory guidelines remains intact and it is unclear what impact future Treasury regulations will have on existing court decisions. *See* text accompanying note 144 *infra.*

In addition, the Treasury favored the inclusion in H.R. 13270 of the rule proposed in H.R. 7489 which would deny installment sale treatment under section 453 for indebtedness issued in registered form or with interest coupons attached. The Treasury felt that these types of instruments, freely traded on the market, do not justify tax deferral. This proposal was adopted, in substance, and resulted in amendment to section 453(b) of the Code.[68] The Treasury also suggested amending section 1232 to require that original issue discount be treated as additional interest income to the bondholders, to be reported ratably over the life of the bonds. The purpose of this proposal was to achieve consistency of treatment between bondholders and the issuing company where bonds are issued at a discount.[69] This proposal also was adopted.

The Senate Finance Committee also proposed some substantive changes in H.R. 13270.[70] The Committee suggested the insertion of a provision distinguishing between debt and equity consideration and proposed a debt-equity ratio test of four-to-one rather than the two-to-one ratio which subsequently prevailed. The Senate version of the bill also proposed reducing the projected earnings test from three to two times annual interest to be paid or incurred. Finally, the Senate version of the bill proposed October 9, 1969, as the effective date of section 279.[71] The effective date recommendation was the only Senate Finance Committee proposal which became law.

The bill which finally emerged and was subsequently enacted into law was quite different from what Mr. Mills had originally intended. Unlike H.R. 7489, sections 411-14 of H.R. 13270 extended to asset acquisitions; partially eliminated the objection that H.R. 7489 contained no control requirement; and, by exempting the first $5 million interest, sought to protect smaller corporations.[72] However, by limiting the scope of the proposal, the drafters of the bill severely limited its effectiveness.[73] The interest deduction ceiling of $5 million is sufficiently high to permit debt-financed acquisition of companies with significant asset size. Moreover, the statute's non-applicability to nontaxable stock acquisitions is a serious legislative omission and is directly contrary to the stated purpose of the legislation. Finally under section 279(d)(3), where control of 80% of the voting stock or of substantially all the assets of the acquired corporation is obtained, the interest on acquisition indebtedness is deductible after the year in which control is obtained and in all succeeding years. This provision

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[68]*See* I.R.C. § 453(b)(3).

[69]*See* S. REP. NO. 552, *supra* note 67, at 146-48.

[70]*Id.*

[71]*Id.*

[72]*See* I.R.C. § 279(i).

[73]*See* text accompanying notes 148-49 *infra.*

encourages control acquisitions which in turn reduce the number of independent companies, a result also contrary to the stated purpose of the legislation. In short, the statute narrows the class of debt-financed acquisitions with no interest deduction penalty to those transactions for which the legislation was supposed to limit further government subsidy.

IV. Technical Explanation of Section 279

Under section 279, no deduction is allowed for interest payable on securities issued after October 9, 1969, which constitutes "corporate acquisition indebtedness" to the extent such "interest"[74] exceeds $5 million less interest on obligations to acquire stock or assets of another corporation issued after December 31, 1967, which are not "corporate acquisition indebtedness" as defined by section 279(b).[75] Thus, interest on any debt satisfying this condition which was issued after 1967 will apply to reduce the $5 million allowable amount. The limited applicability of this provision becomes evident when it is observed that at an average interest rate of 7% a corporation can have $70 million of indebtedness outstanding without having any exposure whatever to the disallowance.[76] Moreover, the limit applies only with respect to indebtedness incurred to buy businesses, and interest the taxpayer may pay on loans obtained for other reasons is not limited by section 279.[77]

The statutory definition of corporate acquisition indebtedness and the Treasury regulations describe the conditions required for disallowing the interest deduction.[78] Corporate acquisition indebtedness is defined in section 279(b) as any corporate obligation evidenced by a bond, debenture, note, certificate, or other evidence of indebtedness issued after October 9, 1969, which satisfies the following four tests — use, subordination, convertibility, and debt-equity or interest coverage ratios.[79]

A. The Use Test

The debt must be issued to provide consideration for the acquisition of stock or assets of another corporation; however, in the case of stock acquisition, no disallowance results unless the issuing corporation owned at least 5% of the voting power of the other

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[74]Treas. Reg. § 1.279-2(b)(2) (1973).

[75]I.R.C. § 279(a)(2); Treas. Reg. § 1.279-1 (1973).

[76]See LeFevre & Lee, *Debt or Equity, Stock Dividends, and Other Corporate Problems*, 23 Tax Law. 511, 519 (1970).

[77]*Id.*

[78]I.R.C. § 279(b); Treas. Reg. § 1.279-3 (1973).

[79]I.R.C. § 279(b).

corporation's stock between October 9, 1969 and the end of the year of issuance of the debt.[80] This eliminates disallowance of deductions of interest on indebtedness for "de minimis" acquisitions of stock.[81] In the case of an asset acquisition, at least two-thirds of all assets (excluding money) used[82] in the acquired corporation's business or trade must be acquired pursuant to a plan.[83] Section 279 also applies to acquisitions effected by exchange of stock in a wholly owned subsidiary of the acquiring corporation. For example, if X Corporation acquires all of the stock of Y Corporation through the utilization of an obligation of Z Corporation, a wholly owned subsidiary of X Corporation, this section will apply.[84]

B. The Subordination Test

The debt must be either subordinate to the claims of trade creditors of the issuing corporation generally or expressly subordinated to any substantial amount of the issuing corporation's unsecured debt. Therefore obligations subordinated to senior indebtedness, but not to trade creditors and unsecured creditors, are not covered by the statute. The test applies whether or not the unsecured debt is presently outstanding or is issued subsequent to the debt issuance's being tested.[85] The Treasury regulations provide that an obligation is expressly subordinated within the meaning of the statute if the obligation is subordinated to right of payment of any substantial amount[86] of unsecured indebtedness.[87] If the issuing corporation is a member of an affiliated group, for purposes of the subordination test, the entire group is treated as issuer.[88] The terms of subordination may be expressed in the debt instrument itself or in another agreement between the parties to the obligation.[89] Moreover:

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[80]*Id.* § 279(d)(5).

[81]S. REP. NO. 552, *supra* note 67, at 143.

[82]For purposes of section 279(b)(1)(B), an asset which has been used in the acquired corporation's trade or business but which is temporarily not being so used shall be treated as if it is being used in such manner. Treas. Reg.§ 1.279-3(b)(4)(i)(1973). This position of the Treasury seems sound from a tax policy point of view since few businesses would hold onto assets for no reason; if an asset were no longer usable, the obvious thing to do would be to sell or dispose of it in the most profitable manner.

[83]I.R.C. § 279(b)(1)(B). Neither the statute nor the Treasury regulations indicate whether the "plan" of acquisition must be formal or if such plan may be informal.

[84]Treas. Reg. § 1.279-3(b)(1)(ii) (1973).

[85]I.R.C. § 279(b)(2)(B).

[86]Treas. Reg. § 1.279-3(c)(2) (1973) defines "substantial amount of unsecured indebtedness" for purposes of section 279(b)(2)(B) as "[A]n amount of unsecured indebtedness equal to 5 percent or more of the face amount of the obligation issued . . . ."

[87]*Id.* § 1.279-3(c)(1)(ii).

[88]*Id.*

[89]*Id.* § 1.279-3(c)(2).

> An obligation is to be considered expressly subordinated whether the terms of the subordination are provided in the evidence of indebtedness itself or in a side agreement and whether the subordination relates to interest or principle or both, but is not to be considered if the subordination occurs solely by operation of law, such as in the case of bankruptcy laws.[90]

C. The Convertibility Test

The debt of a corporation which is used in the acquisition of stock or assets of another corporation, whether a bond or other evidence of debt, must be directly or indirectly convertible into stock of the issuing corporation; or the debt must be part of an investment unit consisting, in part, of an option to purchase stock of the issuing corporation. Non-convertible debt issued with stock warrants or options attached will meet this test.[91] If the issuing corporation is a member of an affiliated group,the convertibility test is satisfied if the debt instrument is convertible directly or indirectly into stock of any member of the affiliated group.[92]

D. Debt-Equity Ratio and Interest Coverage Ratio Tests

Section 279 is applicable if, as of the last day of any taxable year of the issuing corporation in which it issues[93] indebtedness for acquisition purposes, the issuer meets either: (1) A debt-equity test in which the ratio of the issuing corporation's debt to equity exceeds two-to-one,[94] or (2) an interest coverage test where the issuing corporation's "projected earnings"[95] are less than three times the annual interest to be paid or incurred.[96] The definitional rules for both tests are found in section 279(c); in addition the tests are to be applied on the last day of the taxable year in which any indebtedness,

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[90]S. REP. No. 552, *supra* note 67, at 2171.

[91]*Id.* at 2172. *See also* I.R.C. § 279(b)(3)(B).

[92]Treas. Reg. § 1.279-3(d)(2) (1973).

[93]The term "issue" includes giving a note or other debt instrument to a lending institution as well as the giving of a bond or debenture. For registered securities, the date of issue is the date of the first public offering. If the securities are unregistered, the date of issue is the date the obligation is sold to the first purchaser. *Id.* § 1.279-2(b)(1).

[94]I.R.C. § 279(b)(4)(A). Treas. Reg. § 1.279-5(e)(1)(ii) (1973) provides that for purposes of determining a debt-equity ratio, the term "indebtedness" is "determined in accordance with generally accepted accounting principles." The regulation lists a series of items generally considered debt, including the guarantee of the liability of another and contingent liabilities likely to become a reality. *See also id.* § 1.279-5(e)(2), Examples 1 & 2.

[95]*See* text accompanying notes 104-06 *infra.*

[96]I.R.C. § 279(b)(4)(B).

within the interest disallowance rule, is issued to acquire the stock or assets of another corporation.[97] If the debt issue escapes these tests as of the last day of the taxable year, the securities will not constitute "corporate acquisition indebtedness in succeeding years."[98] However, an exception to this rule is that the original debt, if not "corporate acquisition indebtedness" must again be tested on the last day of any subsequent year in which the issuing corporation issues more debt of any kind to acquire more stock or assets of the same corporation.[99] If on a subsequent test date the original debt satisfies the use, subordination, convertibility, and ratio tests, such debt will constitute corporate acquisition indebtedness beginning in the year ending with the subsequent test date.[100] Thus, care must be taken in an acquisition to guard against a disallowance of interest on a prior debt issue given in exchange for stock or assets in the same corporation.

The ratio of debt to equity is computed by comparing all of the issuing corporation's indebtedness with the sum of its money and all other assets less the indebtedness.[101] In determining the amount of equity, the assets are taken at their adjusted basis[102] and measured

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[97]*Id.* § 279(c)(1).

[98]*See id.* §§ 279(b)(4), 279(c)(1), 279(d)(1); *see also* Tiger, *New laws "anti-conglomerate" provisions can be accommodated with proper planning*, 32 J. TAX. 130-31 (1970); Treas. Reg. §§ 1.279-5(b)(2)(i), 1.279-5(b)(3) (1973).

[99]Treas. Reg. § 1.279-5(b)(2)(i) (1973) provides that if the issuing corporation is a member of an affiliated group, subsequent issuance by any other member to acquire stock of the same corporation results in a retesting of the original obligations. *See also id.* § 1.279-5(b)(4), Examples 1 & 2.

[100]H.R. REP No. 413, 91st Cong., 1st Sess. pt. 1, at 105-07, *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1753-55 [hereinafter cited as H.R. REP. No. 413]; I.R.C. § 279(c)(1); Treas. Reg. § 1.279-5(b)(2) (1973).

[101]I.R.C. § 279(c)(2). Asset acquisitions may increase the liabilities of the acquiring corporation, and therefore may be less advantageous than stock acquisitions. *See* Treas. Reg. § 1.279-5(f) (1973).

[102]I.R.C. § 279(c)(2). The question of whether the adjusted basis, which may be more or less than fair market value, is the appropriate value test in cases involving thin capitalization, is still unsettled. For example, in Ainslie Perrault, 25 T.C. 439 (1955), a partnership transferred highly appreciated assets to a newly formed corporation in exchange for cash to be repaid by the corporation in installments. If the transfer had been characterized as a reorganization under section 112(b)(5) of the 1939 Code, the corporation would have taken the shareholder's basis in the assets and the corporation's payments to the shareholders (former partners) would have constituted dividends with no interest deduction allowed to the corporation. This result would have obtained because of the high ratio of debt to equity giving the so-called corporate indebtedness, created by the transfer of the high valued assets, the characterization of capital. Instead, the Tax Court ruled the transaction a bona fide sale such that the corporation obtained as a basis in the assets the fair market value at the date of transfer. It might be of interest that Randolph Paul, a distinguished tax writer and practitioner, represented the taxpayer in *Ainslie.*

In a more blatant abuse of the reorganization basis provisions, the taxpayers in Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967), *rev'g* 239 F. Supp.

against all liabilities, short-term as well as long-term.[103]

Projected earnings[104] are defined as the average annual earnings of the issuing corporation alone, except in situations in which the issuing corporation acquires either stock control or "substantially all the properties" of the acquired corporation.[105] In these situations, "projected earnings" include the average annual earnings of both the issuing corporation and the acquired corporation.[106]

E. Control Requirement

Acquisition of "control," within the meaning of the reorganization definition of section 368(c), of "substantially all the properties" of the acquired corporation requires that the issuing corporation's earnings and interest payments be combined with those of the acquired entity in ascertaining whether the earnings and interest relationship exceeds the statutory ceiling.[107] This principle may be illustrated in the following example from the Treasury regulations:

> Corporation X's earnings and profits calculated in accordance with section 279(c)(3)(B) for 1972, 1971, and 1970 respectively were $29 million, $23 million and $20 million. The interest to be paid or incurred during the calendar year of 1973 as determined by reference to the issuing corporation's total outstanding indebtedness as of December 31, 1972, was $10 million. By dividing the sum of the earnings and profits for the 3 years by 36 (the number of whole calendar months in the three-year period) and multiplying the quotient by 12, the average annual earnings for X Corporation is $24 million. Since the projected earnings of X Corporation do not exceed by 3 times the annual interest to be paid or incurred

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794 (D. Ore. 1965), capitalized a corporation with $1,500 and transferred to the corporation highly appreciated logging equipment worth approximately $200,000 in an alleged sale. To obtain money for the corporate "purchase" the shareholders (former partners and owners of the transferred assets) guaranteed the bank loan to the corporation. The corporation then deducted the interest on the loan and took as its basis in the assets, the fair market value at date of transfer. The basis provisions of section 362 were held inapplicable since the transaction amounted to a "bona fide" sale.

[103]H.R. REP. NO. 413, *supra* note 100, at 105-06.

[104]I.R.C. § 279(c)(3)(A).

[105]Where the projected earnings test includes the earnings of both the issuing and acquired corporations,

> "[S]ubstantially all of the properties" of the acquired corporation means acquisition of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the acquired corporation immediately prior to the acquisition.

Treas. Reg. § 1.279-5(d)(2)(ii) (1973).

[106]I.R.C. § 279(c)(3)(A)(ii).

[107]*Id.* § 279(c)(4)(B). *See also* Silverstein, *supra* note 6, at 376.

(they exceed by only 2.4 times), one of the circumstances described in section 279(b)(4) is present.[108]

F. Determination of Average Annual Earnings

The "average annual earnings"[109] of a corporation are determined by computing the amount of its earnings and profits for any three-year period ending with the last day of the issuing corporation's tax year for which the determination is being made. The computation is made without any reduction for interest paid or incurred,[110] allowed depreciation or amortization,[111] liability for income and related taxes,[112] or dividend type distributions[113] other than from the acquired to the issuing corporation.[114] Those earnings and profits are then reduced to an annual average for the three-year period pursuant to the regulations,[115] taking into account the fact that a corporation was not in existence for the entire three-year period or for only a portion of a year within the period.[116]

G. Rules for Interest Paid or Incurred

The annual interest paid or incurred under section 279(c)(4)(A) is the issuing corporation's interest paid or incurred in a taxable year with reference to its total indebtedness outstanding.[117] If the projected earnings include those of both issuing and acquired corporations,[118] the annual interest to be paid or incurred is that paid by both corporations, determined by reference to their combined total indebtedness outstanding.[119]

H. Section 279 Definition of Corporate Acquisition Indebtedness

Even if debt securities are used in an acquisition, the issue will not be considered corporate acquisition indebtedness under section

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[108]Treas. Reg. § 1.279-5(e)(2), Example 1 (1973).

[109]I.R.C. § 279(c)(3)(A); Treas. Reg. § 1.279-5(d)(3) (1973).

[110]I.R.C. § 279(c)(3)(B)(i). This approach to computation of earnings is sound legislative policy and illustrates the need for redetermination of the utility of the interest deduction generally.

[111]*Id.* § 279(c)(3)(B)(ii).

[112]*Id.* § 279(c)(3)(B)(iii).

[113]*Id.* §§ 279(c)(3)(B)(iv), 301(c)(1).

[114]*Id.* § 279(c)(3)(B)(iv).

[115]Treas. Reg. § 1.279-5 (1973).

[116]I.R.C. § 279(c)(3)(B)(iv).

[117]*Id.* § 279(c)(4)(A). One possible effect of this provision might be the encouragement of corporate management to issue debt at lower interest rates especially where earnings over the three year period are expected to be low.

[118]*Id.* § 279(c)(3)(A)(ii).

[119]*Id.* § 279(c)(4)(B).

279 unless it meets all four tests in section 279(b)(1) through (b)(4).[120] If the debt does not constitute corporate acquisition indebtedness, the interest deduction is not disallowed. Debt may be corporate acquisition indebtedness not only if it is "issued as" consideration for the acquisition, but also if it is issued "to provide" consideration for the acquisition.[121] The House Report indicates that if a corporation issues its obligations as considerations for a bank loan which is used to acquire stock of another corporation, or if the acquiring corporation utilizes the obligations of a related corporation to effect the purchase, such debt may be corporate acquisition indebtedness if the other conditions are met.[122]

I. Special Rules for Banks and Finance Companies

Special rules exist for banks and lending or finance companies,[123] defined as entity businesses engaged in the business of "making loans or purchasing or discounting accounts receivable, notes, or installment obligations."[124] In determining the ratio of debt to equity, the corporation's indebtedness is reduced by the total amount of indebtedness owed to the company and arising out of the lending or finance business.[125] In determining the annual interest to be paid or incurred

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[120]*See* text accompanying notes 81-106 *supra.*

[121]I.R.C. § 279(b)(1). In defining corporate acquisition indebtedness, the regulations use the phrase "direct or indirect" consideration. Treas. Reg. § 1.279-3(b)(2) (1973). According to the Treasury, obligations are issued to provide indirect consideration for an acquisition of either stock or assets if:

> (i) [A]t the time of the issuance of the obligations the issuing corporation *anticipated* the acquisition of such stock or assets and the obligations would not have been issued if the issuing corporation had not so anticipated such acquisition [at the time of the issuance], or where (ii) at the time of the acquisition the issuing corporation *foresaw* or *reasonably should have foreseen* that it would be required to issue obligations, which it would not have otherwise been *required to issue* if the acquisition had not occurred, in order to meet its future economic needs.

Id. (emphasis added). It is apparent that this regulation presents problems of intent (especially in the affiliated group context), burden of proof, reasonableness, and foreseeability. In this period of economic decline, however, litigation of these issues might be postponed, since corporations may issue up to $5 million of debt before the statute even comes into operation.

[122]H.R. REP. NO. 413, *supra* note 100, at 77. Obviously, corporate use of borrowed funds must be recorded in such a manner to accurately reflect the purpose of the borrowing and the relative amounts used for various projects.

[123]I.R.C. § 279(c)(5).

[124]*Id.* § 279(c)(5)(C).

[125]*Id.* § 279(c)(5)(A). One possible legislative purpose for this special rule is to effectively exempt banks and financial institutions from applicability of the statute, since such a reduction all but precludes meeting the 2-to-1 debt-equity ratio test of section 279(b)(4)(A). Perhaps Congress felt interest deduction denial to acquiring financial companies would increase overall interest rates.

by a financial institution, the issuing and acquired corporation, or an affiliated group of which the corporation is a member, a portion of the interest is not taken into account — that part represented by the ratio of the amount of reduced indebtedness to the total indebtedness.[126] In determining the average annual earnings, the amount of the earnings and profits for the three-year period is reduced by the sum of the interest reductions computed under section 279(b)(5)(B).[127]

The following example illustrates this principle:

> As of the close of the taxable year, X Bank has a total indebtedness of $100 million, total assets of $115 million, and $80 million is owed to X Bank by its customers. Bank X's indebtedness is $20 million ($100 million total indebtedness less $80 million owed to the X Bank by its customers) and its assets are $35 million ($115 million total assets less $80 million owed to the bank by its customers). If its annual interest to be paid or incurred is $5 million, such amount is reduced by $4 million:
>
> $$\text{\$5 million interest to be paid or incurred} \times \frac{\text{\$80 million owed to X Bank by its customers}}{\text{\$100 million total indebtedness}}$$
>
> Thus, X Bank's annual interest to be paid or incurred is $1 million.[128]

J. Taxable Years of Interest Deduction Disallowance

The fact that the interest deduction disallowance does not operate at the time the indebtedness is issued because the debt-equity or interest coverage ratio test has failed does not afford a permanent escape. Disallowance may commence with the first taxable year of issuance as of the last day of which the debt-equity or annual interest coverage test is satisfied.[129] Thereafter, under section 279(d)(2), disallowance continues even though the issuing corporation's assets

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[126] *Id.* § 279(c)(5)(B).

[127] *Id.* § 279(c)(5)(C). In the case of affiliated groups, the rules listed above for reducing a financial institution's indebtedness, annual interest paid or incurred, or average annual earnings are taken into account with respect to the group, but the rules are not to apply to reduce the indebtedness of, annual interest to be paid or incurred by, or average earnings of, any corporation in the affiliated group which is not a bank or a lending or finance company. Treas. Reg. § 1.279-5(g)(1)(iii) (1973). Moreover, in determining whether any member of an affiliated group is primarily engaged in the lending or finance business, only the activities of such member corporation are considered. *Id.*

[128] *Id.* § 1.279-5(g)(2).

[129] I.R.C. § 279(d)(1); Treas. Reg. § 1.279-5(b)(2)(ii) (1973).

and earnings may have improved sufficiently to avoid classification of the debt as acquisition indebtedness.[130]

K. Relief Provisions

The general rule is that once the tests prescribed by the Code are satisfied, the interest deduction on that obligation is disallowed for all subsequent years.[131] However, there are exceptions to the general rule. The first applies when control of the acquired corporation is obtained.[132] If, after the first year of disallowance, the issuing corporation acquires all the assets or obtains control of the other corporation, the completed acquisition permits the earnings and profits of both corporations to be combined and the obligation is no longer considered corporate acquisition indebtedness.[133] The second exception applies when the debt-equity or annual interest coverage tests are not met for three consecutive years. The disallowance is eliminated with respect to previously issued obligations for all subsequent years.[134] A third exception applies if a stock acquisition is considered "de minimis." The corporate debt will not be corporate acquisition indebtedness if at the close of the taxable year the issuing corporation owns less than 5% of the total combined voting power of all classes of stock entitled to vote in the other corporation.[135] The fourth exception applies if either of the corporations was newly formed as part of the acquisition, or if the issuing corporation acquires stock in a corporation in which it had section 368(c) control before the transaction.[136]

L. Foreign Corporations and Affiliated Groups

Special rules apply to acquisition of foreign corporations and affiliated groups. An interest obligation incurred to acquire stock of a

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[130]*See* Treas. Reg. § 1.279-5(b)(4), Example 2 (1973). *But see* I.R.C. § 279(d)(4).

[131]I.R.C. § 279(d)(2); S. REP. No. 552, *supra* note 67, at 142.

[132]The inapplicability of the statute to tax free reorganization exchanges under I.R.C. § 368 is a feature which seems to be contrary to the announced purposes of section 279: preventing tax avoidance and discouraging further industrial asset concentration resulting from increased mergers and acquisitions. Under the relief provisions of I.R.C. § 279(d)(3), the allowance of a deduction for interest on transferred debt instruments in addition to nonrecognition of gain or loss on the sale of the acquired corporation would seem to invite the use of debt issuance and control acquisition where possibly neither the use of debt nor acquisition of control would be sought absent the existence of the favorable tax provisions. Accordingly, an investment or capital raising intent may be distorted into undertaking an acquisition in order to obtain the favorable tax benefits.

[133]*Id.* §§ 279(d)(3), 279(c)(3)(A)(ii).

[134]*Id.* § 279(d)(4).

[135]*Id.* § 279(d)(5).

[136]*Id.* § 279(e).

foreign corporation is exempt if substantially all earnings of the foreign corporation for the three years prior to the acquisition or, if shorter, the period of its existence are from foreign sources.[137]

If an issuing corporation is a member of the affiliated group, the various tests are applied treating all members of the affiliated group, other than the acquired corporation, as issuer.[138] The affiliated group will be treated essentially as a single taxpayer regardless of whether a consolidated return is filed. The ratio of debt to equity, the projected earnings, and the annual interest liability of any corporation other than the actual issuing corporation are taken into account as of the particular day such other corporation was a member of the affiliated group. In determining projected earnings of an affiliated corporation other than the issuing corporation, the earnings and profits of the corporation are taken into account only for the period during which it was a member of the affiliated group. The term "affiliated group" has the same meaning as in section 1504 with the exception that the acquired corporation may not be treated as an includible corporation.[139]

M. Changes in Obligation

Section 279(h)(1) provides that the extension, renewal, or refinancing of an obligation is not considered the issuance of a new obligation. Therefore, once disallowance is established, it cannot be avoided by substituting new indebtedness.[140] Similarly, any obligation which is corporate acquisition indebtedness of the issuing corporation is also corporate acquisition indebtedness of any corporation which becomes liable for the obligation as guarantor, endorser, or indemnitor, or which assumes liability for the obligation in any transaction.[141]

N. Contractual Indebtedness Existing Prior to 1969

An additional exemption is provided in section 279 for indebtedness issued after October 9, 1969 to provide consideration for

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[137]*Id.* § 279(f). *See id.* § 862 for rules governing determination of foreign source income. *See also* Crockett & Ashwell, *Federal Taxation of Nonresident Aliens and Foreign Corporations*, 13 DUQ. L. REV. 37, 40 (1974). The $5 million limitation of section 279(a)(1) is reduced, however, by any interest excluded from treatment as corporate acquisition indebtedness because the proceeds are used to acquire a foreign corporation. Treas. Reg. § 1.279-3(g) (1973).

[138]I.R.C. § 279(g).

[139]*Id.*; Treas. Reg. § 1.279-3(b) (1973). *See id.* § 1.279-6 (1973) for required adjustments in determining basis, aggregate money, and assets of an affiliated group. The statutory and Treasury regulation treatment of affiliated groups seems to conform with ownership and control realities in this area.

[140]I.R.C. § 279(h)(1).

[141]*Id.* § 279(h)(2).

acquisition of stock or assets. The exemption is applicable if the acquisition is made pursuant to a binding written contract in effect on October 9, 1969 and at all times thereafter before acquisition, or if the acquiring corporation owned at least 50% of the acquired corporation's stock on October 9, 1969 and at all times thereafter.[142] If obligations are issued to purchase an amount of stock greater than that needed to acquire 80% control, only the proportionate part of the obligations required for the acquisition of the amount of stock necessary for control is to be eligible for this treatment.[143]

O. Effect of Issuer Designation of "Debt"

Section 279(j) provides that designation by an issuer of an instrument as a bond, debenture, note, certificate, or other evidence of indebtedness is not controlling in applying other provisions of the Code to these instruments. Section 385 authorizes the Secretary to promulgate regulations for the determination of whether a corporate interest constitutes stock. Accordingly, Treasury regulations provide that an instrument, the interest on which is "not subject to disallowance under section 279" may constitute a stock interest under section 385, thereby resulting in disallowance.[144] Since a debt arises from an executed contract, it is difficult to understand how the Treasury could, prior to consummation of an acquisition agreement, give a ruling on whether an instrument is debt or equity. Assuming such a determination could be made, section 385 controls section 279 characterization and confusion is likely, especially when the nature of the obligation is changed after an initial determination has been made under section 385.[145] Perhaps when final regulations are issued under section 385, these questions may be resolved.

V. Legislative Inadequacies of Section 279

The enactment of section 279 will not, of course, remedy the inabilities of the antitrust laws to limit industrial asset concentration.[146] The statute's purpose is to provide less tax subsidy for corporate acquisitions.[147] For this purpose, the statute is arguably too narrow in scope in comparison with its proposed predecessor, H.R. 7489. In substance, section 279 has little effect on other inadequacies

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[142]*Id.* § 279(i).

[143]S. Rep. No. 552, *supra* note 67, at 144.

[144]Treas. Reg. § 1.279-7 (1973). Thus, a determination under I.R.C. § 385 controls the literal provisions of section 279.

[145]*See* Bittker & Eustice, *supra* note 10, at 4-19 & n.39.

[146]*See* text accompanying notes 27-30 *supra.*

[147]*See* text accompanying notes 39-41 *supra.*

of the Code which continue to provide tax subsidies for corporate acquisitions.[148] At best, the section constitutes a patchwork remedy and affects only taxable, noncontrol acquisitions. As long as acquiring corporations do not attempt to acquire large corporations, the acquiring firm still has the opportunity to deduct interest payments incurred in financing acquisitions of smaller companies. The so-called financial "highflyers" will still be able to deduct interest payments of up to $5 million on "acquisition indebtedness," thereby enabling them to issue $60 to $70 million of debt in order to finance an acquisition.[149]

The traditional debt vs. equity classification problem, a major issue when the legislation was passed, is not solved by the new rules of section 279; instead, the rules operate in addition to the existing case law principles and problems in this area. Section 385 provides only broad guidelines to be used by the Treasury in making a determination of what constitutes debt or equity and, unfortunately, defers to the Treasury the task of formulating a clear definition of debt and equity.[150] As matters now stand, arguably, a corporation can issue obligations not properly qualifying as debt and still be allowed to deduct the first $5 million of interest.

In addition to the statute's provisions,[151] omissions allow escape from the provisions of section 279. Since section 279(b)(2) requires the obligation to be subordinated either to claims of trade creditors or in right of payment of any substantial amount of unsecured indebtedness, the acquiring corporation could issue unsubordinated debt and thereby escape applicability of the section. Other questions are raised by the use of the term "substantial amount of unsecured indebtedness." The amount of unsecured debt may be substantial even though it constitutes a small fraction of the total debt. This point is somewhat clarified by the regulations,[152] but serious doubts still remain.

The debt-to-equity ratio and projected earnings tests of section 279(b)(4) invite manipulation, since they depend upon the particular date of payment of indebtedness, earnings, and interest. Indebtedness and interest paid can be reduced by acquiring the use of

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[148]*See* I.R.C. § 368 and cross-referenced provisions; *see also* Sandberg, *supra* note 11 *passim;* Crockett, *supra* note 5.

[149]*See* text accompanying note 76 *supra.* Arguably, allowing the first $5 million of interest to be deducted, even where section 279 tests are met, is to equate the first $5 million with the concept of shareholder equity, since such amount constitutes a continuing investment.

[150]*See* text accompanying notes 56 and 67 *supra.*

[151]*See* text accompanying notes 131-36 *supra.*

[152]Treas. Reg. § 1.279-3(c)(2) (1973). The Treasury takes the position that the term "substantial amount of indebtedness" means an amount of unsecured indebtedness equal to 5% or more of the face amount of obligations issued which constitute corporate acquisition indebtedness.

operating business assets under long-term leases rather than by purchase for debt. Indebtedness also can be reduced by payment of outstanding indebtedness shortly before the test date, although a commitment from that particular creditor to re-loan the money shortly after the test date may invite the Service to disregard the temporary reduction in indebtedness. Earnings, moreover, can be increased by any available means of accelerating income into the year ending on the test date.

VI. Impact of Section 279 on Post-1969 Merger Activity

One would expect that the enactment of section 279 would have resulted in a significant decline in tax-free sales of companies in the $80 to $100 million asset range[153] and an increase in the number of acquisitions of smaller companies. One would also expect an increase in the use of debt securities for acquisitions of larger firms. In fact, the available data are not entirely conclusive because of the inadequacy of accurate public information concerning financial structures of the companies in question.[154] Nevertheless, recent

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[153]A company desirous of acquiring another company tax-free, and without running afoul of the $5 million interest deduction ceiling of section 279, must satisfy two major requirements: (a) enough stock or substantially all assets must be acquired to satisfy the control requirements of section 368, and (b) the amount of interest payable on the indebtedness must not exceed $5 million. Thus, assuming that only debt securities are issued and a 7% rate of interest, an acquiring corporation is able to stay within the $5 million interest deduction ceiling only if it issues no more than $70 million worth of debt. The worth of the acquired corporation usually would be limited to approximately $87.5 million.

[154]In studying corporate merger peformance, the Federal Trade Commission lists the consideration transferred for the acquisition as either cash or securities. FTC, Statistical Report: Federal Trade Commission Report on Mergers and Acquisitions (1975) (reports are available for prior and subsequent years). Thus, it cannot be determined what proportion of the securities transferred were actually debt securities cognizable under section 279.

The annual reports of the Securities and Exchange Commission are also not very helpful in this regard, although such reports do contain the total amount of debt securities publicly issued for a given year. *See* 40 SEC Ann. Rep. (1974).

David Penn, formerly with the Federal Trade Commission Bureau of Economics, and James Dalton, economics professor at Southern Illinois University, have observed, generally, that data about corporate finances available to researchers from the usual public sources are highly unreliable and, indeed, misleading in a number of important respects. *See* Dalton & Penn, *Antitrust and the Snare of Published Profit Data: The Need for 'Line-of-Business' Reporting*, 7 Antitrust L. & Econ. Rev. 75, 77 (1974).

The Bureau of Economics of the Federal Trade Commission, in noting the effect of conglomerate expansion, recognized that the loss of financial information is of potentially serious consequence to investors, to policymakers, and upon the sufficient functioning of capital markets. *See* FTC Economic Report-Conglomerate Merger Performance: An Empirical Analysis of Nine Corporations 87 (1972) [hereinafter cited as Empirical Analysis of Nine Corporations].

Federal Trade Commission data compilations[155] for the years 1969 through 1974 indicate the following trend:

Year	Number of Acquisitions	Assets[a] Millions
1969	136	10,996.2
1970	90	5,876.0
1971	58	2,443.4
1972	58	1,860.3
1973	64	3,148.8
1974[b]	62	4,471.3

a/ Acquired firms with assets of $10 million or more.
b/ Figures for 1974 are preliminary.
The above tabulation does not include companies for which data were not publicly available. There were 346 such companies with assets of $8,161.2 million for the period 1948-1974.

The above tabulation indicates that the sharp decline in merger activity occurring immediately after 1969 has reversed. This behavior might be explained by the fact that merger activity tends to parallel periods of economic growth and recession. Significant events in 1969-70 included the Cambodian invasion, the Penn-Central bankruptcy, and the Laos invasion. After a sharp drop in stock averages, the market began to climb only to be met by the wage-price freeze. Following a slight decline, stock averages reached a record high between 1972 and 1973. The Nixon resignation and the American Telephone and Telegraph antitrust suit paralleled another sharp drop in stock averages in 1974. At the time of this writing we are witnessing an overall recovery in stock averages. Thus, there are many factors contributing to corporate merger activity which have little to do with the provisions of a given tax statute and, as much as possible, the analyst must take into account as many variables as available data permit.

In 1974, 3.6% of the total assets acquired through merger involved companies in the $50 to $100 million-plus asset range.[156] Accurate percentage figures for the year 1973 are not available; however, assets acquired in 1974 were 42% higher than in 1973, indicating that on the average much larger companies were acquired in 1974 than in 1973.[157] In 1972, 1.4% of the total assets acquired through merger

[155][1975] FTC STAT. REP. ON MERGERS & ACQUISITIONS 112, Table 12 [hereinafter cited as [1975] FTC REP.].
[156]*Id.* at 17, Table 7.
[157]*Id.* at 109.

involved companies in the $50 to $100 million asset range.[158] These data tend to suggest that section 279 is having a limited impact upon large mergers in recent years. It should also be noted, however, that between 1972 and 1974 roughly 75% of all merger activity involved the acquisition of companies with assets of less than $1 million.[159]

One possible impact of section 279 might be the recognized efforts of corporations to improve their debt-equity ratios.[160] However, this effort did not begin until 1971, two years after the enactment of section 279. In addition, Securities and Exchange Commission registration data are inconclusive since rule 146 fails to effectively limit use of a method for corporations to avoid the registration requirement of rule 145, with the result that there is no information regarding the dollar amount and type of security involved in many mergers.[161] The Securities and Exchange Commission's 1973 data indicate, however, that securities registered for other than cash sales, primarily in connection with mergers and consolidations, rose substantially, reflecting the new registration requirement.[162] Since rule 145 did not become effective until January 1973, further analysis of a comparison of debt and equity issued in connection with mergers must be postponed until sufficient data have been compiled.

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[158][1973] FTC STAT. REP. ON MERGERS & ACQUISITIONS 3, Table 6 [hereinafter cited as [1973] FTC REP.]. This figure, unlike the comparable figures for 1973 and 1974, involves only completed mergers. The figure for completed and pending mergers would be slightly higher. For example, for pending mergers in 1972, 2.5% of the companies to be acquired had assets in size ranging from $50 to $100 million-plus.

[159]The actual figures for the percentage of mergers involving the acquisition of companies with asset sizes under $1 million for 1972 through 1974 are: 78.3% for 1974, [1975] FTC REP., *supra* note 155, at 17, Table 7; 82.2% for 1973, [1974] FTC STAT. REP. ON MERGERS & ACQUISITIONS 15, Table 7; 73.9% [1973] FTC REP., *supra* note 158, at 3, Table 6. It should be noted that in 1972 the data on mergers included separate figures for completed and pending mergers. For 1973 and succeeding years, the data included combined figures for completed and pending mergers.

[160]In its Annual Report the Securities and Exchange Commission observed that, although there were 3,712 registration statements declared effective in 1972 compared with the previous record number of 3,645 effective registration statements for 1969, the total dollar amount in 1972 fell far short of the record $82.5 billion set in 1969. The Commission noted also that there had been steady decline in the dollar value of equity issues between 1969 and 1972 but a steady increase in the dollar value of debt issues. However, since 1972 there has been a much greater decline in the value of debt issued for cash sale compared with equity issues. *See* 38 SEC ANN. REP. 163-66 (1972).

[161]*See generally id.* at 13 for an explanation of the purpose and limitations of rule 145. For an explanation of how the rule is intended to interact with rule 146, see Address by Ray Garrett, Jr., Chairman of Securities and Exchange Commission (April 30, 1974), *reprinted in* J. WIESEN, REGULATING TRANSACTIONS IN SECURITIES: THE EXPANDING IMPACT ON CORPORATE MANAGERS, INVESTORS AND THE FINANCIAL COMMUNITY 97-99 (1975).

[162]39 SEC ANN. REP. 165 (1973).

Given the present level of industrial asset concentration,[163] it would seem that within the next few decades not many healthy, growing firms will remain to be acquired. Thus, the use of debt in corporate acquisitions will necessarily decline with the overall decline in merger activity. Preliminary indications, however, are that the use of registered debt securities in mergers and acquisitions is increasing, at least it was between the years 1973 and 1974. The Securities and Exchange Commission data indicate that debt securities constituted roughly 2.6% of the total $10.5 billion securities issued for other than cash sale in 1973.[164] For fiscal year 1974, the percentage of debt securities constituted roughly 12.5% of a total $12.2 billion securities issued for other than cash sale.[165] Although not indicative of the amount of debt issued in an actual acquisition, the data suggest that section 279 is not significantly thwarting the use of debt in corporate mergers and acquisitions.

VII. Conclusion

Congress should reconsider its responsibility to reduce tax inequities inherent in the Code and should repeal present tax subsidies for corporate acquisitions and other transactions which are not in the public or corporate business interest.[166] It is submitted that corporations and shareholders are not benefited by the decline of competition occasioned by the increased industrial asset concentration resulting from tax-subsidized corporate unifications.[167] Greater industrial asset concentration dictates greater governmental regulation which is counter to the concept of free enterprise and entrepreneurial opportunity.

The $5 million interest deduction ceiling of section 279 effectively exempts many transactions from applicability of the statute. Perhaps the most serious defect in section 279 is its failure to define "equity"

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[163]The 500 largest nonfinancial corporations in the United States control 65% of all sales, 79% of all profits, and employ 76% of all workers engaged in manufacturing. Malley, *The Fortune Directory of the 500 Largest Industrial Corporations*, Fortune, May 1974, at 231. *See also* Study Group on the Federal Budget, Institute for Policy Studies Transnational, The Problem of the Federal Budget (1975), for a thoughtful analysis and discussion of the spending and taxing distortions built into the federal taxation and budgetary process resulting in the increased disparity of economic benefits among individuals and enterprises.

[164]39 SEC Ann. Rep. 165, Table 22 (1973).

[165]40 SEC Ann. Rep. 169, Table 21 (1974).

[166]*See* Surrey et al., *supra* note 36, at 239-99, 341-495, and authorities therein cited; *see also* Hellerstein, *supra* note 5, at 256.

[167]*See, e.g.*, Empirical Analysis of Nine Corporations, *supra* note 154; J. Butters, J. Linter, & W. Cary, Effects of Taxation: Corporate Mergers (1951). *Compare* H. Goldschmid, H. Mann, & J. Weston, Industrial Concentration: The New Learning (1974).

and "debt" for purposes of the statute.[168] An opportunity to squarely face this issue has again been postponed.

Section 279 may, however, provide some deterrence to the use of "debt" securities in acquisitions of large companies. More study is required to determine whether the statute has been a significant factor in the decline of mergers since its enactment.[169] It should be noted, however, that were the use of debt securities in mergers proscribed altogether, firms could resort to the use of other types of securities such as preferred stock, warrants, covertible preferreds, or some combination of any of these. Nevertheless, section 279 does lessen somewhat the tax abuse potential of debt instrument transfers in the corporate merger area.

The major weakness of the statute is its inapplicability, one year after issuance, to tax-free and taxable acquisitions where control is obtained, since these transactions are most likely to include issuance of debt instruments. Accordingly, paragraph 279(d)(3) and subsection 279(e) should be repealed by Congress as inconsistent with the purposes of the statute and as inconsistent with present congressional concern with the adverse political and economic effects of industrial asset concentration in critical markets.[170]

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[168] One can imagine the litigation problems apparent from an inconsistent definition of "debt" for purposes of sections 279 and 385. *See* text accompanying notes 144-45 *supra*.

[169] One significant factor, however, influencing the decline of corporate unifications might be the 1969 amendment to I.R.C. § 1212 allowing corporations selling stock in their poorly performing divisions and subsidiaries to carry back such capital losses as an offset against the prior three years' capital gains. In fact, sales of divisions during the first half of 1970 constituted 33% of all mergers during the same period, a two-fold increase from the amount of such sales in 1969. *See* Ulin, *Environment for Divestment* in TECHNIQUES IN CORPORATE REORGANIZATION 9-11 (W. Mishkin ed. 1972). Accordingly, post-1969 corporate diversification activity indicates a primary motivation on the part of corporate management to maximize profits and internal investment rates of return. Further empirical and formalistic inquiry is necessary to determine more accurately the relative impact of the tax laws on corporate profits and rates of return for given forms of diversification. Appendix A describes corporate and shareholder profit maximization decision models, both of which include the significant tax variants applicable in a diversification decision. Each model, when applied to the various forms of diversification, would provide additional information regarding the actual financial impact of tax variants. *See* Appendix A.

It it likely, moreover, that section 1212 would have more impact on management financial decision-making than section 279, especially during periods of recession when stock prices decline, interest rates rise, and management seeks investment at the lowest cost; a nontaxable capital loss refund, which is accommodated in equation (6) of Appendix A, is a most attractive source of capital under such economic conditions.

[170] *See* Senator Philip Hart's proposed Industrial Reorganization Act, S. 3832, 92d Cong., 2d Sess., 118 CONG. REC. 24928 (1972). For a thoughtful analysis of the above proposals, see Blake, *Legislative Proposals for Industrial Deconcentration*, in H. GOLDSCHMID, H. MANN, & J. WESTON, INDUSTRIAL CONCENTRATION: THE NEW LEARNING 340 (1974).

Appendix A *

Corporate Management and Shareholder Profit Maximization Investment Decision Models

The formal models described below assume a primary management and shareholder motivation to maximize profits and net revenues as contrasted with maximizing gross revenues, rate of growth, earnings per share, or some other measure. Since corporate management units are now considering all forms of diversification in their investment decisions, the models incorporate the possibilities of divestiture and unification, partial or complete.

Nomenclature

A = corporation considering diversification alternatives
S = wholly owned (100% stock) subsidiary corporation of A
T = potential acquisition target corporation
a = constant varying between 0 and 1
b = constant varying between 0 and 1
k = constant varying between 0 and 1

Let the state of nature before a diversification decision be given by:

$$aA + bS - kT \qquad (1)$$

where a = b = k = 1. Thus A + S represents the current net worth of the total assets of corporation A and its subsidiary S.

$$aA + bS + kT \qquad (2)$$

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*The formulations herein commencing with equations (4) and following are the author's modifications of formulations developed by Arnold Reisman which appear in his excellent work, A. REISMAN, MANAGERIAL ENGINEERING AND ECONOMICS (1971). The numbers in the second parentheses of the equations listed correspond to the equation numbers appearing in the Reisman text. Unless otherwise noted, the Reisman equations are not modified. The author wishes to thank Walter Gellhorn and the late Wolfgang Friedman of Columbia University Law School; Donald Warden, President, Cygnus Corporation; Sanford Sarasohn of St. Louis University; Robert Hellawell, William Young, George Cooper, Richard Stone and Kellis Parker of Columbia University; Walter Leonard of Harvard University; Alan Ruben, Stephen Werber, David Goshien, Hyman Cohen, Carrol Sierk and William Tabac of Cleveland State University; David Funk of Indiana University; Laurie Leader of Cleveland State University; Charles Donegan of Howard University; Adrian Kragen, Lawrence Stone, and John McNulty of University of California Berkeley for their help although none are responsible for any errors or policy judgments contained in the article or the appendices.

The author expresses deepest possible appreciation to Dr. Arnold Reisman of the Department of Operations Research, Case Western Reserve University, for taking time to evaluate and discuss developments of the models described and the general application of a systems analysis approach to legislative and judicial decision-making. The author, however, is solely responsible for any possible errors in the formalistic models presented.

where $0 < k \leq 1$
$a = 1$
$b = 1$

describes the Corporation, its division or subsidiary, and a partial to total acquisition of corporation T.

Equation (2) describes a partial to total acquisition of T combined with a partial to total divestiture of S where

$0 < k \leq 1$
$0 \leq b < 1$
$a = 1$

A partial to total divestiture of S with no acquisition is described by Equation (2) where

$k = 0$
$a = 1$
$0 \leq b < 1$

A partial to complete liquidation of A + S exists where

$k = 0$
$0 \leq a < 1$
$0 \leq b < 1$

$$- (aA + bS + kT) \tag{3}$$

describes involuntary liquidation or insolvency where

$k = 0$
$0 < a \leq 1$
$0 \leq b < 1$

Under the above formulations, the constants a, b, and k represent weighted averages of the range of asset and revenue capabilities of corporations A, T, and A's wholly owned subsidiary corporation S.

For purposes of simplification, let us consider only four possible types of diversification:

(a) A + S = management decides there is no advantage to either unification or divestiture;

(b) A - S = management determines that complete divestiture of S is most advantageous;

(c) A - S + T = management determines that total acquisition of T along with complete divestiture of S is most advantageous;

(d) A + S + T = management decides that total acquisition of T is most advantageous.

Now let P represent the present enterprise worth of the ownership and operation of a company after diversification pursuant to any of the above decisions such that:

$$-P = -B + L - E + R \quad [a] \qquad (4)\ (3.3\text{-}5.1R)$$

where B = aggregate purchase price of enterprise assets

L = projected liquidation value of enterprise
E = expenses
R = revenues

For purposes of simplification our general equation assumes either complete acquisition of a target company T or complete liquidation of subsidiary company or division S such that only one purchase or sale is involved in computing the resulting present worth of the enterprise existing after the transaction. In such case, the maximum profit over a given period of time T, measured in years, can be represented by the following equation:

$$-P = -B + L(T)\, e^{-rT} - \int_0^T E(t)\, e^{-rT}\, dt + \int_0^T R(t)\, e^{-rT}\, dt \qquad (5)\ (7.4\text{-}0.1R)$$

where B = aggregate purchase price of enterprise assets

R(t) = projected revenue to time relation
E(t) = projected expense to time relation
L(T) = projected liquidation market value to time relation
r = enterprise cost of capital or discount rate

Equation (5) may be modified by taking into account the corporate tax rate, T^c; corporate tax rate on corporate capital gains, T^{cg}; the nontaxable refund of a capital loss carry-back from sale of stock in an unprofitable subsidiary or division in the amount of $T^{cg}(B^c - P^c)$,[b] namely the product of the capital gains tax rate and the difference between the purchase and sale prices of the loss stock; post-transaction year capital gains; nondeductible interest payments on preferred stock, I^p, at interest rate p.

Now, consider the following variable definitions:

-P = net total enterprise worth discounted at rate, r, over period T.

-B = aggregate purchase price of enterprise assets.

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a. The sign convention used is appropriate for profit maximization studies while the reverse, equally correct, would be better for cost minimization studies. See A. REISMAN, MANAGERIAL AND ENGINEERING ECONOMICS (1971).

b. In 1969, I.R.C. section 1212 was amended to permit corporations experiencing net capital losses to carry back those losses against the prior three years' gains with the government providing a refund within 90 days.

$-C$ = costs of transaction (attorneys, promoters, registration fees).

$L(T)$ = expected market liquidation value of enterprise at end of period T.

T^{cg} = tax rate on corporate capital gains.

B^c = purchase price of capital assets.

P^c = sale price of capital assets.

p = rate of dividends payable on preferred shares.

T^c = corporate tax rate on gross income.

R = gross enterprise revenues.

E = total enterprise expenses deductible from gross income.

I_0 = aggregate enterprise assets represented by common equity at the time of the transaction.

I^R = retained earnings.

I^D = outstanding debt on which interest paid is deductible from gross income.

I^P = outstanding preferred shares with no deduction for dividends paid.

I^{NE} = new common equity issued within a period t.

I^{ND} = new debt securities issued within a period t.

I^{NP} = new preferred shares issued within a period t.

$\bar{r}_a$ = average rate of return on enterprise investments.[c]

E_0 = enterprise operating expenses deductible from gross income.

$\bar{d}$ = rate of interest payable on enterprise debt deductible from gross income, given as a weighted average.

S = salvage value of enterprise assets estimated at end of period t.

N = estimated number of years for useful life of depreciable assets at end of period t.

$\overline{\frac{B-S}{N}}$ = average straight line annual depreciation on enterprise assets.[d]

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c. As defined $\bar{r}_a > r$, the enterprise rate of discount or cost of capital. $\bar{r}_a$ is to be distinguished from shareholder rate of return on equity, corporate rate of return on assets, and corporate rate of return on revenues. For informative discussions on various methods and problems associated with determinations of capitalization rates, see 25 NAT'L TAX J. 193-330 (1972).

d. For simplicity, the model assumes the straight line method of depreciation,

L_0 = net operating loss carryover from prior tax years of either the acquiring or acquired company.

T = finite period of time, in years, over which algebraic sum of enterprise assets is discounted.

t = incremental period of time, in years, within total period of time T.

d_n = rate of interest payable on new debt issued.

A modification of equation (5) can thus be represented by:

$$-P = -B - C + L(T)\, e^{-rT} + (T^{cg})(B^c - P^c)\, e^{-r(T-1)} + \int_{t+1}^{T}(1 - T^{cg})(P^c - B^c)\, e^{-rt}\, dt - \int_0^T (I^P p)\, e^{-rt}\, dt + \int_0^T (1 - T^c)(R(t) - E(t))\, e^{-rt}\, dt \quad (6)^e$$

where: R(t) represents gross revenues as a function of time and E(t) represents deductible expenses as a function of time.

$$R = I_0 \bar{r}_a + I^R \bar{r}_a + I^D \bar{r}_a + I^P \bar{r}_a + (I^{NE} + I^{ND} + I^{NP})\, \bar{r}_a \quad (7)$$

and

$$E = E_0 + I^D\, \bar{d} + I^{ND}\, d_n + \frac{\overline{B - S}}{N} + L_0 \quad (8)$$

Explanation of Terms in Equation (6)

The first term in equation (6) represents the aggregate purchase price of enterprise assets. The second term represents costs of the transaction, which may be significant if securities are issued in connection with the diversification. The third term is the estimated market value of total enterprise assets on liquidation at the end of

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although many, if not most large enterprises use some method of accelerated depreciation permitted by I.R.C. § 167 and the accompanying Treasury regulations.

e. It should be noted that the capital loss carryback refund would be immediately reinvested at the enterprise's rate of return on investment, $r_a > r$, and this annual amount would be taxable gross income; the model assumes this result by positing that the refund amount increases the retained earnings, I^R, in the year of the transaction at time t = 0.

Equation (6) does not contain an explicit expression for the payment by the purchasing corporation of any capital gains taxes to be paid by shareholders of the selling company, but such agreement may be accommodated in the model by appropriate adjustment of the aggregate assets purchase price, -B.

If the transaction involved the sale of loss stock in a poorly performing division or subsidiary, there would be no capital gains in the transaction year and thus the fifth term of equation (6), representing net, after tax capital gains income, is compounded over the period T commencing with the first year after the transaction.

In a similar fashion, the net operating loss carryover, L_0, in equation (8) exists in the year prior to the transaction but under I.R.C. § 381 may offset taxable income in later years provided the requirements of I.R.C. § 382 are met.

period T, discounted at the company's capitalization rate, r. The fourth term is the amount of the corporate capital loss carryover refund received at the beginning of the year after the transaction, t+1, discounted over the remaining period of time T - 1. The fifth term accommodates any anticipated receipt of annual capital gains income, net of corporate capital gains taxes commencing with the year after the transaction; if in the year of the transaction there is no net capital loss, then the integral of the fifth term would range from zero to T. The sixth term represents annual nondeductible dividend payments on preferred shares; the term could be appropriately adjusted to include payments on previously and newly issued preferred shares. The seventh and last term represents annual revenues less deductible expenses and corporate taxes.

Assumptions and Limitations of Model Equation (6)

The factor of possible convertibility of debt securities is not taken into account in the model although such factor would affect the underlying per share equity value of total enterprise assets.

Inflation of the value of assets and increases or decreases in growth rates of rates of return could be accommodated in the model described in equation (6) by appropriate adjustment to $\bar{r}_a$ and r. Accordingly, the formulation of equation (6) is useful for its approximation of the enterprise net worth at a given period of time assuming conditions remain relatively stable over the discounting period. This approximation would enable corporate management to determine the relative enterprise worth, taking into account significant tax factors, for the stated range of forms of diversification.

The model of equation (6) would also allow corporate management and government tax policy-makers alike, to determine the net effect of federal taxes on the form of diversification by solving the equation for the algebraic sum of tax variables and fixing the value of all other variables computing the results for each type of diversification.

Method for Measuring Stock Received by Selling Shareholder

The general form of equation (4) may also be modified to measure the value of stock received in the acquiring company by a shareholder of the acquired company. Consider:

$$-P = - [B_T + (P_T - B_T)] + P_N + D \qquad (9)$$

where:

-P = net value of a share of stock received discounted over a a finite period.

P_T = purchase price of shares in acquiring company.

B_T = average purchase price of shares in acquired company.

P_N = expected future sale price of stock received.

D = annual expected dividends on stock received.

Now, consider the following variable descriptions:

B_T = average purchase price of stock held by shareholder in acquired company.

P_T = price for sale of shares in acquired company received by selling shareholder.

T^g = individual tax rate on capital gains.

R = gross revenues of combined enterprise as defined in equation (7).

T^c = corporate tax rate on gross income.

E = expenses deductible from gross income of combined enterprise as defined in equation (8).

I^R = retained earnings of combined enterprise.

I^P = value of outstanding preferred shares of combined enterprise.

p = rate of dividend payments on preferred shares.

T^P = individual tax rate on preferred dividends.

P_N = expected future sale price of total shares in acquiring company received by selling shareholder.

W_T = net enterprise worth of acquired company as represented by common equity of acquired company.

N_T = number of outstanding shares of common equity of acquired company.

Equation (9) may be modified, considering significant tax variables, resulting in the following formulation:

$$-P = -[B_T + (P_T - B_T)(1 + T^g)] + P_N e^{-rT} + \int_0^T [(1 - T^c)(R(t) - E(t)) - (I^R + I^P p (1 - T^P))] e^{-rt} dt + (P_N - P_T)(1 - T^g) e^{-rt} \quad (10)$$

where:

$$P_T = \frac{W_T}{N_T}, \text{ and} \quad (11)\ (11.1\text{-}2.10R)$$

$$W_T = \frac{I_0 T - I^D{}_T - I^P_T + I^R_T}{N_T} \quad (12)\ (14.2\text{-}2.6R)$$

I_{oT} = enterprise assets of acquired company due to common equity.

I_T^D = outstanding debt of acquired company.

I_T^P = outstanding preferred shares of acquired company.

I_T^R = retained earnings of acquired company.

In equation (10), the first term represents the purchase price of acquiring company shares paid by the selling shareholder of the acquired company including payment of capital gains taxes. If stock in the acquiring company is received in a nonrecognition exchange, T^g would be zero. It should also be noted that P_T in the first term might include an additional amount to compensate the selling shareholder for capital gains tax liability. The second term represents the expected future sale price of acquiring company shares when investment is liquidated. The third term represents the annual dividends received by the shareholder of the selling company on newly acquired shares in the acquiring company. The fourth and last term represents the expected future gain on sale of the shares in the acquiring company after payment of capital gains taxes. Equation (10) could be appropriately modified to accommodate the receipt by the selling shareholder of debt securities in exchange for stock in the acquired company. Such modification would entail adding a positive term for the receipt of annual interest on such debt securities, integrated over the length of the time horizon, T. P_N would then represent the expected value of such securities at the end of the period.

Finally, variables in the third term of equation (10) assume ratable shareholder amounts calculated on a per share portion of total outstanding common equity of the combined enterprise.

Appendix B

Determination of Relative Net Gain From Corporate Issuance of Equal Amounts of Stock or Debt Securities

Variable Description

r_e = corporate investment rate of return

r_i = interest rate payable on debt securities

r_d = dividend rate payable on stock issued

T^c = corporate tax rate on gross income

I^{ND} = amount of new debt issued

I^{NE} = amount of new equity stock issued

G_{ND} = net gain on earnings from proceeds of debt issued after corporate tax

G_{NE} = net gain on earnings from proceeds of stock issued after corporate tax

Now, let $I^{ND} = I^{NE} = 1$. The net proceeds from debt earnings,

$$G_{ND} = r_e I^{ND} - r_e I^{ND} T^c - r_i I^{ND} + r_i I^{ND} T^c \quad (1)$$

The first term to the right of the equals sign is the earnings from the issuance at the corporate internal rate of investment return, less corporate tax on such earnings, less interest payments, plus the tax savings on the deduction of interest payments. Since I^{ND} and I^{NE} are defined as equal to one, equation (1) can be reduced to

$$G_{ND} = r_e(1 - T^c) - r_i(1 - T^c) \quad (2)$$

Similarly, the net proceeds from issuance of an equal amount of stock,

$$G_{NE} = r_e I^{NE} - r_e I^{NE} T^c - r_d I^{NE} \quad (3)$$

The first term to the right of the equals sign is the earnings for the stock issuance proceeds at the corporate internal investment rate of return, less corporate tax on such earnings, less the amount of dividends paid. By simplifying equation (3), it can be reduced to

$$G_{NE} = r_e(1 - T^c) - r_d \quad (4)$$

Subtracting equation (4) from equation (2) we obtain,

$$G_{NE} - G_{ND} = r_i(1 - T^c) - r_d \quad (5)$$

For $G_{NE} - G_{ND}$ to be greater than zero, it is necessary that

$r_i(1-T^c)$ be greater than r_d. Thus, where T^c is 50% (.50),

$\frac{r_i}{2}$ must be greater than r_d, or, (6)

r_d must be less than $\frac{r_i}{2}$ (7)

Thus, assuming issuance of equal amounts of either stock or debt, in order for corporate net gain from equity to exceed that from debt, the dividend rate on the equity must be less than one-half the rate of interest payable on debt, given a corporate tax rate of approximately 50%.

The Requirement of a Second Motion To Correct Errors as a Prerequisite to Appeal

JEFFREY W. GROVE*

I. STATEMENT OF THE PROBLEM

The requirement that a motion to correct errors be filed as a condition precedent to appeal follows from the operation of several of the Indiana Rules of Procedure. The most explicit statement of the requirement is contained in Appellate Rule 4(A). Embodying the familiar principle that appeals be taken from final judgments,[1] Appellate Rule 4(A) provides: "A ruling or order by the trial court granting or denying a motion to correct errors shall be deemed a final judgment, and an appeal may be taken therefrom." Moreover, Appellate Rule 2(A) states that an appeal must be initiated "within thirty [30] days after the court's ruling on the Motion to Correct Errors or the right to appeal will be forfeited." The requirement also emerges, although in different terms, from certain provisions of Trial Rule 59 which is titled "Motion To Correct Errors":

> (G) *Motion to correct error a condition to appeal.* In all cases in which a motion to correct errors is the appropriate procedure preliminary to an appeal, such motion shall separately specify as grounds therefor each error relied upon however and whenever arising up to the time of filing such motion. Issues which could be raised upon a motion to correct errors may be considered upon appeal only when included in the motion to correct errors filed with the trial court.[2]

A complementary provision is set forth in Appellate Rule 7.2 (A)(1)(a): "In all appeals from a final judgment, a certified copy of the

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[1] *See, e.g.*, 28 U.S.C. § 1291 (1974): "The courts of appeal shall have jurisdiction of appeals from all final decisions of the district courts . . . ."

[2] IND. R. TR. P. 59(G). Although the rule states that the motion to correct errors "shall not be required in the case of appeals from interlocutory orders, orders appointing or refusing to appoint a receiver, and from orders in proceedings supplemental to execution," the requirement would seem to be applicable in all other actions which are civil in nature. *E.g.*, O.Q. v. L.R., 328 N.E.2d 233 (Ind. Ct. App. 1975), in which the court held that a statutory requirement for filing a petition for rehearing as a condition precedent to appeal has been superseded by the requirement of a motion to correct errors.

motion to correct errors filed with the trial court shall constitute for all purposes the assignment of errors. No assignment of error other than the motion to correct errors shall be included in the record." Taken together, these rules, and the interpretation given them by the courts,[3] make it clear that in the absence of a motion to correct errors there can be no ruling constituting a final judgment from which an appeal can be taken and, stated otherwise, no error can be preserved or presented for review on appeal.

At the same time, the provisions of these rules are not entirely congruent. The primary tension is created by the language of Appellate Rule 4(A) in which the trial court's ruling on a motion to correct errors is "deemed" to be the "final judgment" from which an appeal may be taken, and the statement in Trial Rule 59(C) that "[a] motion to correct errors shall be filed not later than sixty [60] days *after the entry of judgment.*"[4] Consider the following situation: Following the trial court's entry of judgment, one of the parties files a timely motion to correct errors; in the course of its ruling on the motion, the trial court enters a new judgment. Should a second motion to correct errors addressed to the new judgment be required as a prerequisite to appeal? According to Appellate Rules 4(A) and 2(A) the answer would seem to be "no": the ruling on the motion is "deemed" to be the "final judgment" from which a timely appeal may be perfected. Trial Rule 59(C), however, suggests the necessity of a motion to correct errors directed to the new "entry of judgment." Reading Trial Rule 59(G) and Appellate Rule 7.2(A)(1)(a) together with Trial Rule 59(C), it is plausible to conclude that any error occurring prior to the time when a motion addressed to the new judgment could be filed must be specified in such motion, including error already set forth in the motion to correct errors directed to the original judgment.

II. Evolution of the Requirement

Whether, in the situation described, a second motion to correct errors is a prerequisite to appeal was first considered in *Davis v. Davis.*[5] After the trial court entered judgment granting defendant wife's counterclaim for divorce, defendant filed a motion to correct

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[3]Not long after the current Indiana Rules of Procedure became effective on January 1, 1970, the Indiana Court of Appeals held that "the appealing party must file in the trial court a motion to correct errors as a condition precedent to appeal." Bradburn v. County Dep't of Pub. Welfare, 148 Ind. App. 387, 390, 266 N.E.2d 805, 806 (1971).

[4]Ind. R. Tr. P. 59(C) (emphasis supplied).

[5]295 N.E.2d 837 (Ind. Ct. App. 1973) [hereinafter cited as Davis I], *rev'd on petition for rehearing*, 306 N.E.2d 377 (Ind. Ct. App. 1974) [hereinafter cited as Davis II].

errors. The motion was granted and a new judgment was entered which altered the division of property previously ordered. Thereafter, plaintiff husband filed an appeal challenging "the trial court's granting of defendant wife's motion to correct errors,"[6] but was met with appellee's contention that his failure to file a motion to correct errors "alleging as error the trial court's sustaining of the prior motion"[7] precluded review on appeal. Relying upon the plain wording of Appellate Rules 4(A) and 2(A), the court of appeals rejected the contention. Once the trial court has been given the opportunity to correct its errors, if any, "the party aggrieved by the court's ruling should have the immediate right to appeal the court's ruling."[8] In so holding, however, the appellate court focused on the possible distinction between a ruling which grants the motion to correct errors and one which denies it. Manifestly, the rules make no such distinction, and the practical basis upon which the court repudiated any such distinction is worth quoting at some length.

> Assuming, *arguendo*, the Supreme Court had adopted a rule permitting appeals only from the denial of a motion to correct errors, then in this case, after the court granted the appellee's motion to correct errors, the appellant would have been required to have filed a second motion to correct errors, alleging as error the trial court's granting of the appellee's prior motion, and he would not be permitted to appeal unless and until the trial court denied his motion. As a further extension of this illustration, if the trial court granted the second filed motion to correct errors, then, under appellee's argument, the appellee-wife would have to file the third motion to correct errors before she could appeal the granting of the second motion. Given a difficult or complicated question, or a vacillating trial judge, it is conceivable that the parties could see-saw indefinitely on their motions to correct errors and never progress from the trial court to an appellate level court.[9]

Nevertheless, and quite apart from the matter of a *second* motion to correct errors, it is important to recognize that the situation created by denial of the motion differs from that which obtains when the motion is granted. The party adversely affected by denial of the motion will be the one who has made the motion and asserted errors therein. In the absence of a new judgment, those same errors can be

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[6]295 N.E.2d at 838.
[7]*Id.*
[8]*Id.* at 839.
[9]*Id.*

presented to the appellate court through that motion to correct errors, which constitutes the assignment of errors on appeal. Hence, by virtue of the motion, the trial court has been given an opportunity to correct any perceived error, and such error will be preserved for presentation to the appellate court in proper form. These twin functions of the motion are hereby served.[10] Indeed, should the trial court enter a new judgment in connection with its denial of the motion, still it is arguable that the errors occurring prior to, and included in, the motion should be cognizable on appeal: the trial court has considered them and the motion constitutes the assignment of those errors for appeal purposes. When the motion to correct errors is granted, however, the party seeking appeal from that ruling will not have filed a motion to correct errors. Even in the absence of a new judgment it is difficult to see how, consistent with Trial Rule 59(G) and Appellate Rule 7.2(A)(1)(a), the error relied upon by the appellant can be preserved and presented to the appellate court. The appellant can hardly offer the other party's motion to correct errors as the assignment of errors, for the errors specified therein will not be the errors relied upon for purposes of appeal. As further discussion will reveal, however, this logical trap has not in itself troubled the Indiana appellate courts. Although in *Bradburn v. County Department of Public Welfare*[11] — the first decision to hold that the current rules require the filing of a motion to correct errors as a prerequisite to appeal—the court stated that "the appealing party" must file the motion, in theory either party is permitted to appeal so long as one of the parties has filed a timely motion to correct errors, the ruling on which results in a final judgment.[12]

The holding in *Davis I* remained the law in Indiana for eleven days—until the Indiana Supreme Court handed down its opinion in *State v. Deprez*.[13] *Deprez* was a condemnation proceeding originally brought by the state in 1959. After eleven years, during which the

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[10] In summary, it must be recognized that Trial Rule 59 is the bridge between the trial and appellate court systems.

Trial Rule 59(A) permits the trial court to correct error on its own initiative, and as such it is exclusively concerned with the trial court.

But equally clear is counsel's duty to make a motion under Rule 59, meaning that the provision is as concerned with the beginning of an appeal as it is correcting error in the trial court, in the sense that counsel's eye must rest on the appellate court as well as the trial court when the motion is made. Thus, it is observed that the Rule permits the court to correct error on its own motion and decision, but apparently it would still be counsel's duty to make the Motion to Correct Error in order to preserve the points for appeal.

4 W. HARVEY, INDIANA PRACTICE 129 (1971).

[11] 148 Ind. App. 387, 266 N.E.2d 805 (1971).

[12] See note 19 *infra* and accompanying text.

[13] 260 Ind. 413, 296 N.E.2d 120 (1973).

trial date had passed without any action or appearance by the state, the landowners filed a verified motion to dismiss for lack of prosecution pursuant to Trial Rule 41(E). On November 4, 1970, the trial court entered a judgment of dismissal. Thereafter, on January 4, 1971, the state filed a timely motion to correct errors which was subsequently denied. In ruling on the motion, however, the trial court set forth for the first time its special findings of fact and conclusions of law and entered a new judgment of dismissal. The state then appealed without filing a motion to correct errors addressed to the second entry of judgment, and appellee sought to have the appeal dismissed on the ground that a second motion to correct errors addressed to the new entry of judgment was a condition precedent to appeal. The Indiana Supreme Court accepted appellee's argument.

The court began with the question of "what constituted the final judgment referred to"[14] in Appellate Rule 4(A), found that the initial entry of dismissal "would have been final"[15] absent the state's motion to correct errors, and concluded that, for purposes of Rule 4(A), the ruling on the state's motion would have constituted the final judgment "[i]f the trial court had simply either granted or denied"[16] the motion. But this analysis is both misleading and fallacious. The question was not "what" constituted the final judgment under Appellate Rule 4(A), for the rule clearly deems the ruling on the motion to correct errors to be the final judgment from which appeal may be taken. Rather, the question was whether "any" such final judgment had resulted in view of the state's failure to file a second motion directed to the new entry of judgment of dismissal. That is, because Trial Rule 59(C) calls for a motion to correct errors "after the entry of judgment," it is arguable that the state's failure to file a second motion resulted in a failure, pursuant to Trial Rule 59(G), to preserve any error for appeal. By no means could the initial entry of judgment itself have been "final" for purposes of Appellate Rule 4(A), as the court seems to have suggested,[17] and the difficulty created by

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[14] *Id.* at 420, 296 N.E.2d at 124.

[15] *Id.*

[16] *Id.*

[17] Elsewhere in its opinion the court referred to the second entry of judgment as the "final judgment," but the context suggests that the term "final judgment" was not being used in an Appellate Rule 4(A) sense. *See* 260 Ind. at 420, 296 N.E.2d at 124. Instead, the court was probably referring to the entry of judgment mentioned in Trial Rule 59(C). The general imprecision of the court's analysis is also evident from its statement that "there having been no Motion to Correct Errors directed to the February 3, 1971 entry, that entry has become the entry from which no appeal has been taken." *Id.* An appeal is taken not from "the entry of judgment" but from the ruling on the motion, if one is filed.

the absence of a second motion is attributable directly to the provisions of Trial Rule 59(C) and (G), rather than to the terms of the Appellate Rule.

The court's statement that the ruling on the state's motion would have constituted a final judgment "[i]f the trial court had simply either granted or denied the motion" was explained thusly:

> However, because of the insufficiency of the November 4, 1970 entry in the light of the attack made upon it by the State's Motion To Correct Errors, the trial court entered a completely new entry of February 3, 1971, pursuant to Rule TR. 52(B), constituting new findings of fact and a new judgment as authorized further by Rule TR. 59(E). This new entry for the first time set forth the reasons in fact and in law upon which the trial court's dismissal was based. If they were in error, then a Motion To Correct Errors was clearly necessary.[18]

In other words, if the trial court committed error in its ruling on the motion which resulted in a new judgment, such error had to be specified in a second motion to correct errors. Presumably, therefore, if a trial court "simply" grants or denies the motion, without more, neither additional error nor a new judgment is possible. Still, it is difficult to imagine how a trial court could ever *grant* a motion to correct errors without making findings contrary to or in addition to those supporting the judgment. Certainly, a trial court can "simply" *deny* a motion to correct errors without making any findings or conclusions and, if it does so, denial of the motion will in no way affect the judgment. But how a trial court can, within the contemplation of *Deprez*, "simply" *grant* a motion to correct errors is not apparent, for the granting of *any* relief must be predicated on error which must first be "found." Moreover, the very correction of error will appear as error to the party adversely affected by the granting of the motion and the effect of the ruling necessarily will be to supersede the entry of judgment, irrespective of the relief granted. Nevertheless, as the opinion in *Davis I* demonstrates, there is no compelling reason to provide the trial court with an opportunity to review the corrections it has just made. Further, the appealing party's failure to file a motion which can serve as the assignment of errors on appeal has not been regarded as an independently significant basis for insisting on the motion. Indeed, the *Deprez* formulation purports to authorize direct appeal by a non-moving party when the motion is "simply" granted.[19]

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[18]260 Ind. at 420, 296 N.E.2d at 124.

[19]*See* Easley v. Williams, 314 N.E.2d 105 (Ind. Ct. App. 1974). In three other cases the non-moving party sought and was denied appeal; in each case, however,

Although the trial court in *Deprez* had formally entered a new judgment, the supreme court's analysis did not appear to make the requirement of a second motion contingent upon a second "formal" entry of judgment. The clear implication was that when the trial court does anything other than "simply" grant or deny the motion it creates a new final judgment to which a new motion to correct errors must be directed as a condition precedent to appeal. As subsequent cases reveal, this has become an exact statement of the rule.

While the holding in *Deprez* was the first such result under the current Indiana Rules of Procedure, it is clear that prior practice was marked by similar holdings with regard to the motion for new trial—the predecessor to the motion to correct errors. In *Hedworth v. Chapman*,[20] the appellant had filed a second motion for a new trial following an amendment of a prior judgment, and the appellate court stated: "The appellant's motion for new trial addressed to the last decision is the determining factor as to the questions presented to us in this appeal. We will consider the assignment of errors based upon the second motion for new trial."[21] No authority was cited for this procedure. The first case in which an appellant was penalized for failure to file a second motion for new trial was *Newton v. Board of Trustees for the Vincennes University*.[22] The defendant had filed a motion for new trial following the trial court's entry of judgment and while the motion was pending the plaintiff filed a motion to modify this judgment, which was granted. The trial court then overruled defendant's motion and defendant appealed. The appellate court ruled that appellant's first assignment of error—that the trial court erred in overruling appellant's motion for new trial—presented nothing for its consideration.

The appellate court decided two subsequent cases, *Hunter v. Hunter*[23] and *Eilts v. Hines*,[24] by application of the rule announced in *Newton*. In each of these cases the only assignment of error was the overruling of appellant's motion for a new trial which had been presented to the trial court prior to its entry of a modified judgment. Judges White and Sullivan both dissented from the majority's dismissal of the appeals in these cases. The principal thrust of their dissents was that the motion for new trial was directed not at the

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appeal was frustrated by appellant's failure to file a motion directed to the new entry of judgment, rather than by failure to file *any* motion. Davis II, 306 N.E.2d 377 (Ind. Ct. App. 1974), see notes 28 and 29 *infra* and accompanying text; State v. Kushner, 312 N.E.2d 523 (Ind. Ct. App. 1974); Miller v. Mansfield, 330 N.E.2d 113 (Ind. Ct. App. 1975).

[20]135 Ind. App. 129, 192 N.E.2d 649 (1963).

[21]*Id.* at 132, 192 N.E.2d at 650.

[22]142 Ind. App. 391, 235 N.E.2d 84 (1968).

[23]247 N.E.2d 236 (Ind. Ct. App. 1969).

[24]146 Ind. App. 197, 257 N.E.2d 683 (1970).

actual entry of judgment, but at the verdict or decision; therefore, unless there had been a change in that verdict or decision, even if the judgment itself was modified, there was no need for a second motion. While this reasoning is no longer applicable under the current rules—the motion to correct errors is clearly directed to the entry of judgment—some of the observations contained in these dissents are currently relevant. In *Hunter*, Judge White stated:

> It would seem to me a more practical rule and a more logical rule to hold that the first motion for new trial is mooted by the subsequent modification of the findings or decision only to the extent that the modification renders moot the grounds for new trial stated in the first motion.
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> . . . .
>
> What is the logic, reason, common sense, or purpose of requiring the losing party to file a second motion for new trial repeating exactly the words of the first motion in specifying a claim of error which has not been in any way affected by the entry of a modified finding or decision?
>
> In my opinion a second motion for new trial is never necessary to preserve on appeal such error as was properly asserted in an earlier timely motion for new trial and not cured by a subsequent modification of the Court's decision.[25]

Similar observations were made by Judge Sullivan in his dissent in *Eilts*.[26] Obviously, both judges were disturbed by the harshness of a rule which was utilized to foreclose appeal without adequate justification. It is equally disturbing that a wholesale revision of Indiana's Rules of Procedure failed to remedy this problem.

III. Application of the Requirement

Following the supreme court's decision in *Deprez*, the court of appeals considered appellee's petition for rehearing in *Davis v. Davis* and, in *Davis II*,[27] overruled its earlier decision. Although Judge Buchanan's opinion observed that the appellate court "could not be made aware of the alleged errors asserted on appeal"[28] since the appellant had not filed any motion to correct errors, it was appellant's failure to file a motion directed to the new entry of judgment, rather than his failure to file *any* motion, which was decisive.[29] The

[25]247 N.E.2d at 242-43 (White, J., dissenting).

[26]146 Ind. App. at 200-04, 257 N.E.2d at 684-86 (Sullivan, J., dissenting).

[27]306 N.E.2d 377 (Ind. Ct. App. 1974).

[28]*Id.* at 380.

[29]As discussed at note 12 *supra* and accompanying text, it is difficult to see how an appellant who has filed no motion to correct errors can preserve error under Trial Rule 59(G) or present error to the appellate court pursuant to Appellate Rule

principal rationale for regarding the absence of a subsequent motion as fatal was explained by the court. "The trial court was never afforded the opportunity to correct these alleged errors associated with its amendment of the prior judgment. It is this opportunity to correct error which is the paramount purpose underlying the requirement of filing a motion to correct errors in the trial court."[30] Assuming the validity of this purpose, still it would appear that the trial court in *Davis* was given ample opportunity, when it considered and granted appellee's motion, to consider the very matter which appellant sought to raise on appeal—that is, whether the trial court committed error in amending the judgment. To insist that the trial court be afforded a chance to correct error allegedly resulting from its correction of error raises the spectre of a potentially endless series of motions. Justification for such a result follows only from a mechanical application of Trial Rule 59(G). It is particularly suspect in light of the assumption that a party who has filed no motion can appeal if only the ruling on appellee's motion did not amount to a new entry of judgment under Trial Rule 59(C),[31] for in this situation the non-moving party has specified no error to the trial court and, according to Appellate Rule 7.2(A)(1)(a), has no vehicle for presenting the error on appeal.

Further applications of the *Deprez* doctrine have not been in short supply, and of all the subsequent cases in which a second motion was not filed, only one survived for appellate consideration on its merits.[32]

In *Wyss v. Wyss*,[33] the trial court granted summary judgment in favor of defendant based upon plaintiffs' failure properly to verify their complaint in proceedings contesting the validity of a will. In denying plaintiffs' timely motion to correct errors, the trial court supplemented its reason for granting summary judgment; it found that any request that plaintiffs may have made to amend the verification had not been in writing and was, therefore, improper. It further found that plaintiffs' applications to amend the original complaint by supplying proper verification were made at times after the applicable statute of limitations had expired and were, therefore, properly denied. To the court of appeals it was "readily apparent that the Court altered and amended its original findings by making new and additional findings,"[34] and the court held that "a subsequent motion to correct errors directed to this ruling was required to have

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7.2(A)(1)(a). Nevertheless, *Deprez* would permit an appeal in such circumstances if the trial court has "simply" granted appellee's motion.

[30]306 N.E.2d at 380-81.

[31]See note 19 *supra* and accompanying text.

[32]Easley v. Williams, 314 N.E.2d 105 (Ind. Ct. App. 1974).

[33]311 N.E.2d 621 (Ind. Ct. App. 1974).

[34]*Id.* at 625.

been filed in order to preserve any error on appeal."[35] That the effect of the trial court's ruling was the same as its original judgment was apparently inconsequential, just as it had been in *Deprez*.

In *State v. Kushner*,[36] a condemnation action, defendant landowners were awarded a jury verdict in the amount of $19,000 and the trial court entered judgment on the verdict. Dissatisfied with the amount of damages awarded, defendants filed a motion to correct errors. In ruling on the motion, the trial court found that the damages occasioned by the condemnation were insufficient in view of the reduction in value to other land owned by defendants. Thus, the court granted the motion to correct errors and ordered a new trial subject to additur. The court of appeals ruled that the trial court's disposition of the motion to correct errors involved "new and additional findings of fact and altered and amended the original judgment."[37] Because the condemnor had failed to present a motion to correct errors addressed to the trial court's ruling on the motion to correct errors, no appeal was permitted.

A different result obtained, however, in *Easley v. Williams*.[38] In this action for personal injuries, the jury returned a verdict for defendants and judgment was entered accordingly. In granting plaintiff's motion to correct errors, the trial court agreed that it had committed error in giving certain instructions and ordered a new trial. Defendant Easley filed a motion to correct errors directed to this ruling, while the other defendants did not. All defendants appealed and plaintiff moved the appellate court to dismiss the appeal of those defendants who had failed to file a motion to correct errors addressed to the court's ruling on plaintiff's motion to correct errors. In denying the motion to dismiss the appeal, the appellate court distinguished this case from previous cases in which a second motion to correct errors had been required. "[I]n each of those earlier cases, a new judgment resulted from the trial court's ruling on the original Motion to Correct Errors. However, in this case, the court's ruling on the Motion to Correct Errors abolished the original judgment by granting a new trial, and no new judgment resulted. Therefore, no subsequent Motion to Correct Errors was required."[39] The court apparently believed that the trial court's ruling on plaintiff's motion to correct errors did not involve new findings of fact or conclusions of law although its obvious effect was to abolish—and, to that extent, alter and amend—the original judgment. Rather, the trial court had, in the words of *Deprez*, "simply" granted the motion

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[35]*Id.* at 626.
[36]312 N.E.2d 523 (Ind. Ct. App. 1974).
[37]*Id.* at 526.
[38]314 N.E.2d 105 (Ind. Ct. App. 1974).
[39]*Id.* at 108.

to correct errors, which action "constituted the final judgment from which this appeal could have been taken."[40] Thus, parties who filed no motion to correct errors were allowed to appeal. That one appellant had filed a motion, however, might explain how the errors relied upon were included in the record on appeal.

The requirement of a second motion to correct errors was imposed once again in *Koziol v. Lake County Plan Commission.*[41] Following the trial court's entry of judgment, appellants filed their motion to correct errors. As in *Deprez* and *Wyss*, the ruling on the motion did not change the result reflected in the original judgment. Still, having found that the trial court "did make several new and additional findings not contained in his original judgment,"[42] the court of appeals concluded that a second motion to correct errors was required and dismissed the appeal.

Weber v. Penn-Harris-Madison School Corp.,[43] like *Kushner*, was a condemnation action in which judgment was entered on the jury's verdict in favor of the condemnees. Thereafter, the parties on both sides of the action filed motions to correct errors. The trial court denied the condemnor's motion but granted the condemnees' motion pursuant to two specifications of error. It determined that the condemnees were entitled to interest on the jury's verdict and entered judgment for the condemnees reflecting a damage award greater than that found by the jury. In so doing, the trial court expressly vacated and set aside the original judgment on the verdict. No motion to correct errors was directed to the trial court's action. The court of appeals dismissed, because "if the trial court, in ruling on the motion to correct errors, does anything other than simply granting or denying the motion, that ruling becomes a new judgment to which a new motion to correct errors must be directed. Therefore *any* amendment of a judgment creates a new judgment which requires a motion to correct errors."[44]

In *Hansbrough v. Indiana Review Board*,[45] the trial court sustained defendant's motion to dismiss. In response to plaintiff's motion to correct errors addressed to the dismissal, the court, for the first time, entered findings of fact and conclusions of law, and denied the motion. Plaintiff did not file a motion to correct errors addressed to the court's disposition of the motion. Although the trial court at no point explicitly ordered entry of judgment, the court of appeals found that the ruling on plaintiff's motion to correct errors was sufficiently

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[40]260 Ind. at 420, 296 N.E.2d at 124.
[41]315 N.E.2d 374 (Ind. Ct. App. 1974).
[42]*Id.* at 375.
[43]317 N.E.2d 811 (Ind. Ct. App. 1974).
[44]*Id.* at 813 (emphasis by the court).
[45]326 N.E.2d 599 (Ind. Ct. App. 1975).

final to be regarded as a final judgment. Plaintiff's failure to present a second motion to correct errors directed to this judgment was considered fatal for purposes of appeal and the appeal was, therefore, dismissed. Judge Sullivan concurred in the result but detected a different problem. In his view, the appeal was properly dismissed, not because a second motion to correct errors had not been made, but because the trial court had never entered a judgment to which a motion to correct errors could have been filed.[46]

Of the cases just rehearsed, all but *Easley* were dismissed on appeal because appellants failed to file a motion to correct errors addressed to the trial court's disposition of the motion to correct errors which had been presented. Dismissal of the appeal in each of these cases can be justified on the authority of *Deprez*. In each case the court of appeals properly found that the trial court had made new findings of fact and/or conclusions which either altered the basis for the original judgment or, for the first time, explained the rationale for the judgment. Such being the case, it was of no moment that the rulings in *Wyss*, *Koziol*, and *Hansbrough* produced the same results as the original judgments. Indeed, *Deprez* itself was such a case. In addition, that no new judgment was formally entered in either *Wyss* or *Kushner* was unimportant since the new or additional findings and/or conclusions themselves constituted new judgments.

The decision in *Easley*, however, is consistent with *Deprez* only if the court of appeals was correct in its view that the trial court made no additional findings on the motion to correct errors, but rather merely granted the motion. How this magic was performed is not apparent. In fact, it appears that in granting a new trial based upon the findings of error in giving certain instructions, the trial court did indeed make new findings.

In *Miller v. Mansfield*,[47] an action for injuries sustained in an automobile collision, a jury verdict was returned in favor of defendants, and plaintiffs thereafter filed a timely motion to correct errors. The trial court overruled plaintiffs' motion in part, and sustained it in part, granting them a new trial. In the entry embodying its ruling on the motion, the court specified the errors supporting its grant of a new trial. From this ruling defendants took a timely appeal, without filing a subsequent motion to correct errors. The court of appeals, presumably upon its own motion, dismissed the appeal, holding that the trial court's ruling on plaintiffs' motion to correct errors constituted a new final judgment, thus necessitating the filing of a second motion to correct errors as a prerequisite to appeal. The question as framed by the appellate court all but answered itself: "The sole question . . . is whether, *following the entry*

[46] *Id.* at 603-05.

[47] 330 N.E.2d 113 (Ind. Ct. App. 1975).

of judgment by the trial court granting, in part, appellees' motion to correct errors and ordering a new trial, it was necessary that appellants file a motion to correct errors."[48] Of course, if a new entry of judgment resulted from the trial court's ruling, as assumed in the court's statement of the question, then on the authority of *Deprez* a subsequent motion to correct errors was necessary as a prerequisite to the appeal. But the court did not analyze the trial court's ruling on the motion to correct errors to determine whether, in fact, it constituted a new judgment. Rather, it simply found that the ruling was "deemed" a final judgment by operation of Appellate Rule 4(A).[49] Thus, the very provision which arguably dispenses with the need for filing a subsequent motion to correct errors was seized upon as the basis for application of the *Deprez* rule requiring a second motion to correct errors. Judge Garrard dissented, stating that though he approved of the *Deprez* rule, he felt that it had been misapplied by the majority. He argued that no new judgment had been created, and that the error which the majority required to be presented in a second motion to correct errors had already been considered by the trial court in ruling on appellees' motion. Further evidence of what Judge Garrard termed a "blind application"[50] of the rule was the majority's citation of *Easley v. Williams*[51] as authority for its holding in *Miller.* However, in *Easley,* a case whose facts are indistinguishable from those in *Miller,* the court held that no second motion to correct errors was required, and thus refused to dismiss the appeal.

In *Minnette v. Lloyd*[52] the controversy centered on the question of which municipal agency had authority to promulgate rules and regulations concerning appointment of members to the Evansville Fire Department. Plaintiffs sought an injunction to restrain the Board of Public Safety from retaining a certain employee as a member of the Fire Department. Defendants counterclaimed for a declaratory judgment that the Board of Public Safety has sole authority in this area. The trial court found against the plaintiffs on their complaint and against defendants on their counterclaim; judgment was entered accordingly. Both plaintiffs and defendants filed motions to correct errors directed to the judgment. The trial court overruled both motions but, in so doing, entered a corrected judgment to the effect that it found for defendants on their counterclaim. Plaintiffs appealed without filing a motion to correct errors directed to the corrected judgment. The court of appeals dismissed the appeal on defendants-appellees' motion, holding that

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[48] *Id.* at 114 (emphasis supplied).
[49] *Id.* at 115.
[50] *Id.* (Garrard, J., dissenting).
[51] 314 N.E.2d 105 (Ind. Ct. App. 1974).
[52] 333 N.E.2d 791 (Ind. Ct. App. 1975).

"[a]bsent a motion to correct errors directed at the final judgment and a ruling either granting or denying the motion, this court is without jurisdiction to entertain plaintiffs' appeal."[53] The court's analysis of the lower court's ruling provides convincing support for application of the *Deprez* rule in this case. "In the original judgment the court left the parties where it found them, with no direction as to which body had authority to promulgate the rules in question. The corrected entry granted that authority to the defendant Board of Public Safety thereby declaring the respective privileges and responsibilities of the parties for the first time."[54]

In *Lake County Title Co. v. Root Enterprises, Inc.*,[55] appellant took the precaution of filing a second motion to correct errors only to be met with appellee's contention that such motion was unnecessary and that, therefore, failure to have perfected the appeal within the allotted time following the ruling on the initial motion called for dismissal of the appeal. After the trial court gave judgment for plaintiff on its complaint for damages, defendant filed a timely motion to correct errors which alleged, in part, that the trial court erred in its findings on the issue of damages. The trial court granted the motion in this respect, reducing the award, while overruling defendant's motion in all other respects. Defendant then filed its second motion to correct errors directed at the trial court's ruling on the initial motion. The trial court overruled this second motion, and defendant perfected its appeal. The court of appeals agreed with appellee that if the second motion were not required the appeal would have to be dismissed as untimely. Moreover, the court acknowledged that "[i]t might be contended that the present case is distinguishable from . . . [prior] cases because in the present case the first judgment was not expressly vacated and no new or additional findings of fact or conclusions of law were entered when the judgment was modified."[56] Nevertheless, the court refused to dismiss the appeal. Therefore, the rule to be derived from *Lake County Title* is that any amendment or other alteration of a judgment produces a new judgment which requires a second motion to correct errors as a prerequisite to appeal.

Wireman v. Wireman,[57] like *Lake County Title*, reached the appellate court following the filing of a second motion to correct errors. Unlike the earlier case, however, in *Wireman* each of the two motions was made by different and opposing parties. This was a divorce action in which the petitioner-wife was granted a divorce and custody of the children, with visitation rights in the respondent-

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[53] *Id.* at 792.

[54] *Id.*

[55] 339 N.E.2d 103 (Ind. Ct. App. 1975).

[56] *Id.* at 107.

[57] 343 N.E.2d 292 (Ind. Ct. App. 1976).

husband. The respondent was ordered to pay child support and alimony in the form of a property settlement which was contingent on petitioner's compliance with respondent's visitation rights. Petitioner then filed a motion to correct errors, alleging error in the trial court's determination of the value of the parties' total assets, and in its imposition of the contingency. In ruling on petitioner's motion, the trial court ordered respondent to pay support arrearage and alimony in a lump sum payment. Respondent then filed a motion to correct errors contesting the change in the method of payment of alimony and the removal of the contingency. Eventually the trial court overruled respondent's motion and this appeal followed. Presumably, the court of appeals approved of respondent's action in filing the subsequent motion to correct errors; though the court did not discuss the necessity of the motion, it entertained the appeal on its merits.

The final case in this area is *Campbell v. Mattingly*.[58] This was an action by a father and son for personal injuries sustained by the son. The jury awarded damages to both father and son and the trial court entered judgment on the verdict. Defendants then filed their motion to correct errors asserting, in part, that the award to the father was not supported by the evidence. The trial court agreed with this assertion, ordered a remittitur, and entered a modified judgment. Defendants appealed without filing a second motion directed to this modified judgment. The court of appeals dismissed the appeal due to the absence of a second motion. Consider, however, the likely sequence of events at the trial court level had the defendants satisfied this so-called jurisdictional requirement. After the trial court granted remittitur defendants would have filed another motion to correct errors. This second motion would have been substantially identical to the original motion; only allegations of error in the amount of the award to the father would have been omitted. Indeed, even these allegations would have been included had defendants felt that the father's award, as modified, was still unsupported by the evidence. Thus the trial court would have been considering the same allegations a second time. Such an approach is an unconscionable waste of everyone's time, including that of the trial court. And when this approach is not followed, the unfairness in denying appellant the opportunity to appeal is manifest.

IV. Conclusion

The necessity of a second motion to correct errors as a prerequisite to appeal is the result of an internal procedural logic (or illogic) which ignores the needs and demands of litigants. It is the product of

[58]344 N.E.2d 858 (Ind. Ct. App. 1976).

wooden adherence to the requirement that a motion to correct errors be filed after "the entry of judgment" pursuant to Trial Rule 59(C), and to the provisions of Trial Rule 59(G) which make preservation of errors for appeal contingent upon their inclusion in a motion to correct errors. But the requirement of a second motion virtually ignores that language in Appellate Rule 4(A) which authorizes appeal from a ruling granting or denying a motion to correct errors.

The most straightforward and most rational solution to the difficulties in this area would be to eliminate the motion to correct errors as a prerequisite to appeal, making it optional at the trial court level.[59] The motion would still be available as the vehicle for seeking relief from error at the trial court level and appropriate relief still could be given by the trial court sua sponte. Moreover, the errors asserted on appeal could easily be presented by means other than a motion to correct errors. Parties in federal court, where the motion to

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[59]The Indiana Civil Code Study Commission Comments to then-proposed Trial Rule 59 cites eleven reasons for elimination of the motion to correct errors as a condition to appeal. See 4 W. HARVEY, INDIANA PRACTICE 119-20 (1971):

> Following are some of the important reasons for eliminating the motion to correct errors (replacing the prior motion for a new trial) as a condition to an appeal:
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> First: It will assure consideration of cases upon the merits, rather than solution on technical grounds which must be blamed only on the lawyer taking the appeal or the very uncertainty of the technical law involved.
>
> Second: The motion to correct error seldom is effective below. It is common knowledge that not more than 2% or 3% of all cases are reversed when the motion is made. It therefore wastes everybody's time.
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> Third: The transcript of evidence seldom, if ever, is available to aid a party in determining whether or not prejudicial error was committed. Consequently, a lawyer cannot fairly present the issues for correction within the time provided, and out of caution he is forced to raise issues which may prove not to be reversible error.
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> Fourth: The expenses of reproducing the motion for a new trial, rather than emphasizing the actual events in the record where error was committed are costly, and time consuming.
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> Fifth: Past experience has shown a tendency upon the part of courts on appeal to develop technical language for assigning error on appeal especially when such error must go through a series of restatements in motions, briefs and arguments.
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> Sixth: In criminal cases, the technical limitation that all errors be raised within a relatively short period of time after the trial and before the transcript is prepared is almost unbelievable in this day when the rights of those accused of crimes are so well recognized.
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> Seventh: The real effect of requiring a motion for a new trial is to consume time and promote delay. The delay involved often is such that, if generally known, it would lead to more radical innovations. *Compare, e.g.*, Indianapolis Life Ins. Co. v. Lundquist, 222 Ind. 359, 53 N.E.2d 338 (1944).
>
> Eighth: If the trial judge is permitted to serve as a court of appeal, his decision on questions of law raised by the motion to correct error is made without the benefit of briefs which represent the final step in the appeal

correct errors is unknown, seem to have no special difficulty in apprising trial courts of the existence of trial error, and there is no evidence that the federal appellate courts cannot do their jobs without having issues on appeal formulated in a motion to correct errors.

Even if this solution is not adopted, still there is room for improvement, for the requirement does not take into account the waste of time involved in requiring that the trial court rule on the same allegations of error more than once. In most cases in which the motion is denied the second motion will merely repeat the allegations of error contained in the original, excepting those errors which were corrected by the trial court, and/or adding allegations of error, if any, made in connection with the ruling on the original motion. At the very least, those allegations of error which are unaffected by the ruling on the initial motion should be considered on appeal even without a second motion. Surely consideration of alleged errors by the trial court in its ruling on the initial motion should be sufficient to satisfy the requirement of Rule 59(G) and preserve those errors for appeal. If the appellant fails to file a subsequent motion, it would be simple enough to hold that only error connected with the trial court's ruling on the original motion is waived. Moreover, when the motion to correct errors is granted there is no real need to afford the trial court an opportunity to reconsider the matters it has already considered in making its ruling on the motion—that is, to correct errors the court has allegedly committed in correcting errors. Indeed that such opportunity is not critical is apparent from the *Deprez* formulation (as applied in *Easley*) which contemplates direct appeal by a party who has filed *no* motion so long as the court's ruling on the motion presented is a simple granting of the motion which produces a "final judgment." But, of course, in *granting* a motion a court will of necessity find error (as it did in *Easley*); nevertheless, absent a new judgment, the non-moving party may appeal from the ruling without asking the trial court to consider whether it committed error in correcting error.

Further, should the current doctrine persist, an alternative to dismissal of an appeal would be for the appellate court merely to

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process. Briefs cannot be artfully drawn without the transcript and the record which usually are not available in the time and place where the motion is made below.

Ninth: Judges on appeal often admit that failure to raise error properly below is an effective means of allowing them to dispose of the cases. If the case is without merit, or if it is poorly presented, the proper remedy is by means of the court's power to deal with counsel, and in all cases with the merits.

Tenth: In view of the over-all ineffectiveness of the motion to correct error (formerly motion for a new trial), it presents, in final analysis, a

suspend the appeal, providing the appellant with an opportunity to perfect an appeal by the belated filing of a second motion to correct errors with the trial court.[60] Following the trial court's ruling on the belated motion, the appellate court could resume jurisdiction.

At the workaday level the impact of the *Deprez* doctrine and its application is obvious. A motion to correct errors should always be filed when the trial court, in ruling on a previous motion to correct errors, supports its disposition of the motion upon any rationale other than that marshalled in support of the original judgment. In such circumstances, a motion to correct errors addressed to that disposition should always be made in order to insure the availability of appellate review. Of course, the exercise of such caution will itself activate the need for further precaution. Since appellate counsel will have to guess at whether the appellate court will regard disposition of the second motion to correct errors as the final judgment, it will be necessary to perfect appeal from the disposition of the first motion to correct errors as well. Strict compliance with the other requirements for perfecting appeal, and with the timetables applicable thereto, should be made against the possibility that the appellate court will deem the ruling on the first motion as the final judgment. That such extraordinary protective measures are necessary, however, demonstrates the undesirability of utilizing the motion to correct errors as a prerequisite to appeal.

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technical obstacle in the way of consideration of a case upon its merits. Parties who feel that relief can be obtained below are free to seek it. As a mandatory rule it presents an unreasonable cost to the time of professors, students and lawyers in getting to the merits on an appeal.

Eleventh: The old rule followed in Indiana has long since been rejected in the federal courts and other jurisdications where effort has been made to eliminate delay and cost in judicial administration.

Reasons in support of alternative Rule 59(g) and in support of the old rule requiring a motion to correct error as a condition to appeal are not convincing. The new rule meets the argument that the judge below should be allowed to correct his errors, since the parties have the option of presenting a motion to correct errors and the judge may do so on his own motion. However, the Commission was divided upon the question, and therefore seeks assistance of the bar and public.

[60]*See* Davis II, 306 N.E.2d 377, 382 (1974) (Sullivan, J., concurring).

The Federal Long-Arm: The Uses of Diversity, or 'Tain't So, McGee

RICHARD H. SEEBURGER*

The due process clause of the fourteenth amendment to the Constitution of the United States prevents the courts of a state from exercising in personam jurisdiction over a defendant who never has had any contacts with that state. Whether the due process clause of the fifth amendment would similarly limit the United States District Court for that district, sitting in diversity jurisdiction, has yet to be answered. There are presently a number of situations in which federal courts exercising diversity jurisdiction do reach absent parties a state court could not. These deserve critical examination since they, along with some Supreme Court dicta, serve as authority for a proposition which, if fully utilized, could have a profound impact on individuals in our federal system.

The American Law Institute (ALI) has proposed expansion of diversity of citizenship jurisdiction in heretofore frustrating multi-party, multi-state situations,[1] primarily to reach those absent who are necessary for a just adjudication of the claim. The fact that territorial limitations constitutionally prevent any state from achieving jurisdiction to resolve such a dispute[2] suggests to the ALI that the solution, if any, is to be found at the federal level, arguably in the article III authority for diversity jurisdiction. This proposed new jurisdiction, original and by removal, with only minimal diversity required, would encompass those cases in which there are several parties necessary for a just adjudication who are not all amenable to service under any one state's jurisdiction.[3] Another proposed change, in interpleader, makes a corporation incorporated in more than one place a citizen of that jurisdiction which will establish diversity.[4]

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[1]American Law Institute, STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS (1969) [hereinafter cited and referred to in text as STUDY].

[2]Hanson v. Denckla, 357 U.S. 235 (1958). *See* quotation in note 29 *infra.*

[3]ALI STUDY, *supra* note 1, §§ 2371, 2373. Section 2371 provides for original jurisdiction when defendants necessary for a just adjudication of plaintiff's claim are beyond the reach of any one state. Section 2373 provides for removal when a dispersed party is necessary to a defendant. Section 2374(b) proposes giving the district courts nonreviewable discretion on motion or sua sponte to transfer such cases to any other district for the convenience of the parties or witnesses, or otherwise in the interest of justice.

[4]*Id.* § 2375.

The ALI, conscious that its proposals raise constitutional issues, appended Supporting Memorandum B to the *Study*.[5] The memorandum is brief but, given the paucity of available authority, brevity is not its principal weakness. It suffers from addressing the wrong issue. It attempts to show a federal power to provide for nationwide service of process in all diversity cases rather than those limited situations to which the ALI *Study* was addressed. Secondly, it does not confront a concern that has been voiced in several lower federal courts, a possible fifth amendment due process *limitation* on such service of process.

The memorandum proceeds from the assertion that most existing authority draws no distinction between congressional power to provide for nationwide service of process in cases involving the enforcement of federal law and the power so to provide in diversity of citizenship cases. The dearth of authority to the contrary is taken as proof of the existence of a power never exercised as such and in any event never directly challenged. The memorandum asserts that the pattern of not crossing state lines in diversity cases is a product of congressional choice rather than constitutional limits.[6] The existing authority relied on consists of Supreme Court dicta and two statutes which provide for extraterritorial service of process in stockholder's derivative actions and interpleader cases.

This Article will examine the authorities relied on by the memorandum and other authorities, including developments since the appearance of the ALI *Study* in which rights beyond state lines have been affected by the actions of United States courts sitting in diversity. Finally, this Article will suggest a constitutional justification for extra-state service of process in some, but not all, diversity cases, while recognizing an important difference between cutting off the interests of an absent plaintiff and imposing liability on an absent defendant.

I. The ALI's Authorities

The most prominent authority cited in the *Study* is the statement of a unanimous Supreme Court (Mr. Justice Jackson not participating) that "Congress could provide for service of process anywhere in the United States."[7] This dictum by the Supreme Court must be

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[5] *Id.* at 437-41.

[6] That the former is true does not establish the latter. The memorandum points out that for one year under the Judiciary Act of 1801 one district did disregard state lines, encompassing the District of Columbia and parts of Maryland and Virginia. Act of Feb. 13, 1801, Ch. 4, §§ 4, 21, 2 Stat. 89, 96, *repealed* Act of March 8, 1802, Ch. 8, § 1, 2 Stat. 132. The early Congresses were not the final word on the powers of federal courts under article III. *See* Marbury v. Madison, 5 U.S. (1 Cranch) 87 (1803).

[7] Mississippi Publishing Corp. v. Murphree, 326 U.S. 438, 442 (1946). The issue was whether Federal Rule 4(f) could authorize service of process in the Southern

taken as especially considered, since it came only a year after the Court's extensive treatment of the extraterritoriality of state court jurisdiction in *International Shoe Co. v. Washington.*[8] The primary authority for the Court's assertion was *Toland v. Sprague.*[9] Neither case, however, involved service of process beyond that which the state court could have accomplished.[10] Such a statement from a Supreme Court without contradiction or dissent, albeit with only fiat authority, is certainly impressive. Further, the statement implicitly contains two critical assertions. The first is that there resides somewhere in the Constitution the grant of substantive power to provide for nationwide service of process in a diversity case. The second is that this power is in no way limited by the due process clause of the fifth amendment.[11]

The memorandum also draws support from the majority's refusal to respond to Mr. Justice Black's dissent in *National Equipment Rental, Ltd. v. Szukhent,*[12] in which he directly raised the

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District of Mississippi when a diversity action was properly laid in the Northern District. Subsequently Mr. Justice Jackson in his plurality opinion in National Mutual Ins. Co. v. Tidewater Transfer Co., 337 U.S. 582 (1949), said, "The defendant here does not challenge the power of Congress to assure justice to the citizens of the District by means of federal instrumentalities, or to empower a federal court within the District to run its process to summon defendants here from any part of the country." *Id.* at 590. The basis for federal jurisdiction in this case, however, was not diversity.

[8]326 U.S. 310 (1945).

[9]37 U.S. (12 Pet.) 300 (1838). The following statement appears in the case: "Congress might have authorized civil process from any circuit court, to have run into any state of the Union." *Id.* at 328. This diversity case was commenced, however, by a writ of foreign attachment against the property of the absent defendant, expressly authorized today under Federal Rule 4(e). The Court cited no authority for its statement.

[10]The Court also cited two other cases, United States v. Union Pac. R.R., 98 U.S. 569 (1878), and Robertson v. Railroad Labor Bd., 268 U.S. 619 (1925), neither of which was a diversity case.

[11]Whether such due process limits apply when jurisdiction is based on *federal question* has not been authoritatively answered. *See* Oxford First Corp. v. PNC Liquidating Corp., 372 F. Supp. 191 (E.D. Pa. 1974) and the discussion of authorities at 198-205. The court applied "traditional procedural due process notions as *a part* of a judicial fairness test rather than impose the *International Shoe* mandate of due process on federal nationwide service of process statutes." *Id.* at 203 (emphasis in original). The court overruled the objections of California defendants to suit in Pennsylvania based on false and misleading financial statements, inducing an exchange of stock, because the defendants knew that their financial statements would be sent to and used by the plaintiff concern in Pennsylvania. Should such limitations apply in federal question jurisdiction, it seems clear they would apply in diversity.

[12]375 U.S. 311 (1964). The pertinent language in the dissent is as follows:

> It has been established constitutional doctrine since *Pennoyer v. Neff* was decided in 1878, that a state court is without power to serve its process outside the State's boundaries so as to compel a resident of another State against his will to appear as a defendant in a case where a personal judgment is sought against him. This rule means that an individual has a

point. In issue was whether defendants were properly served under Federal Rule 4(d)(1) and that turned on the factual dispute of whether they had appointed a particular individual their agent for receiving service of process in their contract with plaintiff. The majority ruled they had, so no comment on the point raised in the dissent was necessary.[13]

Finally, the memorandum draws support from the acceptance in lower federal courts without apparent question of two acts of

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constitutional right not to be sued on such claims in the courts of any State except his own without his consent. The prime value of this constitutional right has not diminished since *Pennoyer v. Neff* was decided. Our States have increased from 38 to 50. Although improved methods of travel have increased its speed and ameliorated its discomforts, it can hardly be said that these almost miraculous improvements would make more palatable or constitutional now than in 1878 a system of law that would compel a man or woman from Hawaii, Alaska, or even Michigan to travel to New York to defend against civil lawsuits claiming a few hundred or thousand dollars growing out of an ordinary commercial contract.

It can of course be argued with plausibility that the *Pennoyer* constitutional rule has no applicability here because the process served on the Szukhents ran from a federal, not a state, court. But this case was in federal court solely because of the District Court's diversity jurisdiction. And in the absence of any overriding constitutional or congressional requirements the rights of the parties were to be preserved there as they would have been preserved in state courts. Neither the Federal Constitution nor any federal statute requires that a person who could not constitutionally be compelled to submit himself to a state court's jurisdiction forfeits that constitutional right because he is sued in a Federal District Court acting for a state court solely by reason of the happenstance of diversity jurisdiction. The constant aim of federal courts, at least since *Erie R. Co. v. Tompkins*, has been, so far as possible, to protect all the substantial rights of litigants in both courts alike. And surely the right of a person not to be dragged into the courts of a distant State to defend himself against a civil lawsuit cannot be dismissed as insubstantial. Happily, in considering this question we are not confronted with any congressional enactment designed to bring nonstate residents into a Federal District Court passed pursuant to congressional power to establish a judicial system to hear federal questions under Article III of the Constitution, or its power to regulate commerce under Art. I, § 8, or any of the other constitutionally granted congressional powers; we are dealing only with its power to let federal courts try lawsuits when the litigants reside in different States. Whatever power Congress might have in these other areas to extend a District Court's power to serve process across state lines, such power does not, I think, provide sound argument to justify reliance upon diversity jurisdiction to destroy a man's constitutional right to have his civil lawsuit tried in his own State. The protection of such a right in cases growing out of local state lawsuits is the reason for and the heart of the *Pennoyer* constitutional doctrine relevant here.

Id. at 330-32 (Black, J., dissenting) (citations omitted).

[13]It is clear that the state rules could have authorized service of process. The focus of the dissent above quoted was on *Erie* rather than due process. It may well have been prompted by Abraham, *Constitutional Limitations Upon the Territorial Reach of Federal Process*, 8 VILL. L. REV. 520 (1963).

Congress authorizing such nationwide service of process.[14] Support, rather, should be drawn from the lack of direct challenge.

The "support" that Supporting Memorandum B lends, then, is simply the assertion that there is no difference in federal court between the authority of Congress to provide for nationwide service of process to enforce federal laws that have a nationwide effect and its authority to provide for nationwide service of process to enforce laws whose effect has a territorial limitation by virtue of their authority being derived from state sovereignty.

There are, however, areas of support not relied on by the Memorandum — at the Supreme Court, congressional, and lower federal court levels — which suggest a difference between reaching absent plaintiffs and absent defendants. It is to these authorities this Article now turns.

II. Other Authorities

Nationwide service of process[15] in statutory interpleader[16] cases has more authority behind it than the fact that Congress thought it could do it. Of the cases[17] that have reached the Supreme Court, resort to nationwide service of process was had in all but one.[18] In one

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[14]The memorandum cites by way of reference Steinberg v. Hardy, 90 F. Supp. 171 (D. Conn. 1950), involving 28 U.S.C. § 1695, providing for extraterritorial service of process over the corporation in stockholder's derivative actions, and Great Lakes Auto Ins. Group v. Shepherd, 95 F. Supp. 1 (W.D. Ark. 1951), involving 28 U.S.C. § 2361, providing for such service over claimants in interpleader cases. While what Congress thought about its powers is clear from a reading of the statutes, it is difficult to see what the reference to these two cases adds. Furthermore, the issue was not raised in the *Steinberg* case. A more appropriate citation would have been Overfield v. Pennroad Corp., 113 F.2d 6 (3d Cir. 1940), the only case involving such a direct challenge under that statute. The authority given by the circuit court there was a perfunctory reference to cases involving a federally created cause of action, including those cited in note 10 *supra*. The interpleader case is an interesting reference. There were cross-claims between defendant claimants unrelated to the fund deposited in court. As to those defendants who were served under the statute but who did not submit themselves to the jurisdiction of the court, the claims were *dismissed*, albeit on the grounds that they were unauthorized under Federal Rule 13(g) since they did not arise out of the same transaction or occurrence. *See* discussion in note 88 *infra*.

[15]28 U.S.C. § 2361 (1970).

[16]*Id.* § 1335.

[17]Griffin v. McCoach, 313 U.S. 498 (1941) is excluded from consideration here since there was no appeal from the grant of relief in interpleader below. The sole question before the Supreme Court was the choice of law rule in second stage interpleader, *i.e.*, the dispute among the claimants once the stakeholder is given relief by a discharge from liability beyond the fund deposited in the court.

[18]Levinson v. United States, 258 U.S. 198 (1922). The citizenship of the claimants does not appear. It would seem that jurisdiction was not based on diversity, but rather on 28 U.S.C. § 1345 with the United States as plaintiff. In any event, the Court said, "[A]s all the parties consented to jurisdiction we do not feel called upon to raise a question on that score." *Id.* at 200. Certainly the Court could not have been referring to

case relief was denied.[19] Of the remaining cases, three involved problems of subject matter jurisdiction under 28 U.S.C. § 1335[20] and one involved a problem of jurisdiction to grant ancillary relief.[21] In none of these six cases was a challenge to nationwide service of process made and the Supreme Court itself gave no indication that a future challenge would be fruitful.

A second, and perhaps more far-reaching, area of support not relied on by the ALI may be found in the acquiescence of the Supreme Court and Congress[22] in certain amendments to the Federal Rules of Civil Procedure in 1963 and 1966 authorizing district courts to "reach" parties beyond the boundaries of the state in which the court sits.

In 1963, amendments to Federal Rule 4(f) were adopted to provide for service beyond the territorial limits of the state, but within 100 miles of the place in which the action is commenced or to which it is assigned or transferred for trial, for persons who are brought in as parties pursuant to Federal Rule 13(h) as additional parties, or Federal Rule 14 as third parties, or Federal Rule 19 as additional parties joined when needed for a just adjudication.[23]

In 1966 a rewriting of the class action provisions of Federal Rule 23 was adopted, changing the impact of a judgment adverse to extraterritorial class members. Rule 23(c)(2) now requires a member of a "spurious" class to "opt out" rather than permitting him to "opt in." The new class provided for in Federal Rule 23(b)(2), designed to cover actions in the civil rights field in which "the party opposing the class has acted or refused to act on grounds generally

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subject matter jurisdiction. In context, however, it seems probable the reference is not to personal jurisdiction either, but to "equitable jurisdiction" to grant relief in interpleader, since it was suggested the stakeholder did not stand indifferent as then required by 28 U.S.C. § 1335.

[19]The eleventh amendment was held to preclude federal jurisdiction in Worcester County Trust Co. v. Riley, 302 U.S. 292 (1937). An executor was unable to interplead the different states which claimed his decedent was their resident for purposes of inheritance taxes. The Court held that the possibility of conflict of decisions between the courts of two states is not forbidden by the Constitution. Thus a suit against the tax collectors was held to be a suit against the states since the officers would not be acting beyond the limits of the states' lawful power. *But cf.* Western Union Tel. Co. v. Pennsylvania, 368 U.S. 71 (1961), discussed *infra* at note 95.

[20]State Farm Fire & Cas. Co. v. Tashire, 386 U.S. 523 (1967); Treinies v. Sunshine Mining Co., 308 U.S. 66 (1939); Sanders v. Armour Fertilizer Works, 292 U.S. 190 (1934). In the first two cases the Court raised the issue itself.

[21]Dugas v. American Sur. Co., 300 U.S. 414 (1937).

[22]The Congress does not always acquiesce in the product of the Advisory Committee of the Judicial Conference. *See* 28 U.S.C.A. Legislative History, FEDERAL RULES OF EVIDENCE, at 825-26.

[23]The Advisory Committee cited Mississippi Publishing Corp. v. Murphree, 326 U.S. 438 (1946), as authority so to provide.

applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole," provides no "opt out" opportunity.[24]

III. Recent Lower Federal Court Practices

Lower federal courts have considered the extraterritorial impact of the 1963 and 1966 amendments. In addition they have decided a number of cases since the ALI *Study* involving statutory interpleader and pendent jurisdiction of a state claim on a federal cause of action, when nationwide service of process was used. Many of the courts were not as satisfied as the ALI was with the legitimacy of nationwide service of process in any and all diversity cases. Their concern was not, as was Justice Black's,[25] with the source of federal power so to provide, but rather with limitations on any such power that fundamental fairness notions of due process might impose.

Those lower federal courts that confronted the issue did not seek to equate the minimal contacts standard applied under *McGee v. International Life Insurance Co.*[26] with that which might be applicable to the exercise of federal power. The basis of the state court's power is that it is sovereign within a defined territorial area.[27] That this is a necessary limitation upon power became somewhat obscured in the cases dealing with the "presence" of foreign corporations.[28]

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[24]Congress was careful, however, to limit extraterritoriality in the Multidistrict Litigation Act, 28 U.S.C. § 1407 (1970), authorizing transfer only for pretrial purposes and requiring remand to the original district for trial. "Pretrial proceedings" has been held to include the granting of summary judgment. Humphreys v. Tann, 487 F.2d 666 (6th Cir. 1973), *cert. denied*, 416 U.S. 956 (1974). The Rules of Procedure of the Judicial Panel on Multidistrict Litigation provided for transfer for trial across district lines, § 5.3, or across circuit lines, § 5.4, but only in compliance with 28 U.S.C. § 1404(a) (1970), to a district where the action might have been brought, *i.e.*, where service over the defendant could have been obtained.

[25]*See* note 12 *supra.*

[26]355 U.S. 220 (1957).

[27]Pennoyer v. Neff, 95 U.S. 714, 723 (1877):

> [T]he exercise of jurisdiction which every State is admitted to possess over persons and property within its own territory will often affect persons and property without it. To any influence exerted in this way by a state affecting persons resident or property situated elsewhere, no objection can be justly taken; whilst any direct exertion of authority upon them, in an attempt to give ex-territorial operation to its laws, or to enforce an ex-territorial jurisdiction by its tribunals, would be deemed an encroachment upon the independence of the State in which the persons are domiciled or the property is situated, and be resisted as usurpation.

[28]*See, e.g.*, McGee v. International Life Ins. Co., 355 U.S. at 222-23:

> Since *Pennoyer v. Neff*, this Court has held that the Due Process Clause of the Fourteenth Amendment places some limit on the power of state courts to enter binding judgments against persons not served with process within their boundaries. But just where this line of limitation falls has been the

However, the point was forcefully reasserted in *Hanson v. Denckla.*[29] Assuming the power of the federal government to provide for service of process across state lines in diversity cases, it is not restricted by the inherent limitations of a territorial sovereignty, *i.e.*, the encroachment on another sovereign, at least in those kinds of cases over which no one state could acquire jurisdiction. While the lower federal courts seemed to assume the power to cross state lines for certain purposes, they were uncomfortable with the notion that such power can run to the outermost limits of the borders of the United States of America.

The cases considered in the lower federal courts, in order of their complexity, involve (1) pendent jurisdiction, (2) Federal Rule 4(f), (3) Federal Rule 23, and (4) 28 U.S.C. § 2361.

A. Pendent Jurisdiction

A problem of extraterritoriality under the doctrine of pendent jurisdiction arises when a complaint based on a federal cause of action for which nationwide service of process has been authorized[30]

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subject of prolific controversy, particularly with respect to foreign corporations. In the continuing process of evolution this Court accepted and then abandoned "consent," "doing business," and "presence" as the standard for measuring the extent of state judicial power over such corporations. See Henderson, The Position of Foreign Corporations in American Constitutional Law, c. V. More recently in *International Shoe Co. v. Washington*, the Court decided that "due process requires only that in order to subject a defendant to a judgment *in personam*, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.' "

Looking back over this long history of litigation a trend is clearly discernible toward expanding the permissible scope of state jurisdiction over foreign corporations and other nonresidents. In part this is attributable to the fundamental transformation of our national economy over the years. Today many commercial transactions touch two or more States and may involve parties separated by the full continent. With this increasing nationalization of commerce has come a great increase in the amount of business conducted by mail across state lines. At the same time modern transportation and communication have made it much less burdensome for a party sued to defend himself in a State where he engages in economic activity.

(citations omitted).

[29]357 U.S. 235, 251 (1958):

Those restrictions are more than a guarantee of immunity from inconvenient or distant litigation. They are a consequence of territorial limitations on the power of the respective States. However minimal the burden of defending in a foreign tribunal, a defendant may not be called upon to do so unless he had the "minimum contacts" with that State that are a pre requisite to its exercise of power over him.

[30]*See, e.g.*, 15 U.S.C. §§ 78aa, 77v(a) (1970).

contains a count based on state law. Courts which have considered the issue have split fairly evenly, all agreeing that the issue is only one of statutory construction.[31] Those dismissing the pendent claim view Congress as having intended to authorize service for the limited purpose of deciding the "case" created by federal law.[32] Pendent jurisdiction, it is argued, goes only to subject matter jurisdiction and not to personal jurisdiction. That argument, however, was turned around by the only circuit court to consider the point directly:

> Congress has bestowed upon the United States District Courts the power to extend their writ extraterritorily so as to compel a personal appearance before them. Once the defendant is before the court, it matters little, from the point of view of procedural due process, that he has become subject to the court's ultimate judgment as a result of territorial or extraterritorial process. Looked at from this standpoint, the issue is not one of territorial in personam jurisdiction — that has already been answered by the statutes — but of subject matter jurisdiction. It is merely an aspect of the basic pendent jurisdiction problem.[33]

B. Federal Rule of Civil Procedure 4(f)

Much the same reasoning has been used in the lower federal courts to support the 100 mile bulge amendment to Federal Rule 4(f) in 1963. Since the bulge provision is limited to service under Federal Rule 14 (upon a person not a party to the action who is or may be liable to him for all or part of the plaintiff's claim against him) or under Federal Rule 19 (upon a person needed for a just adjudication), the subject matter is properly seen as ancillary rather than pendent.

When the original subject matter jurisdiction is not based on diversity the additional party, who was served only on the state rather than the federal cause of action (but who could have been made subject to the federal cause by Congress in order to completely adjudicate the federal cause of action under ancillary jurisdiction), presents a problem not significantly different from that of the party who is served under a federal cause of action but must also respond to a state cause of action under pendent jurisdiction. Thus in *Coleman v. American Export Isbrandtsen Lines, Inc.*[34] a longshoreman allegedly

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[31]*See* Mills, *Pendent Jurisdiction and Extraterritorial Service Under the Federal Securities Laws*, 70 COLUM. L. REV. 423 (1970).

[32]*See, e.g.*, Wilensky v. Standard Beryllium Corp., 228 F. Supp. 703, 705-06 (D. Mass. 1964); Ferguson, *Pendent Personal Jurisdiction in the Federal Courts*, 11 VILL. L. REV. 56 (1965).

[33]Robinson v. Penn Central Co., 484 F.2d 553, 555 (3d Cir. 1973).

[34]405 F.2d 250 (2d Cir. 1968).

injured in New Jersey on defendant's ship sued the shipowner in New York, and a claim over was made against the Philadelphia stevedoring corporation not doing business in New York. Congress could have given a cause of action against the stevedoring company just as it could completely subsume a pendent state claim based on a controversy which it could regulate exclusively. The problem therefore is not of constitutional dimensions when the basis of jurisdiction originally was not diversity and the 100 mile bulge is limited to Rules 14 and 19.[35]

However, when the original cause of action is based exclusively on state law, the problem of service under Rule 4(f) cannot be resolved on the basis of Congress' ability to provide for the convenient resolution of federally based claims. Only one such case arose, *Pierce v. Globemaster Baltimore, Inc.*,[36] in which a diversity action was brought in Maryland against a Maryland manufacturer of rope whose negligence allegedly caused the rope to break resulting in the death in Pennsylvania of plaintiff's decedent. Defendant filed a third party complaint under Federal Rule 14, served in eastern Pennsylvania under amended Federal Rule 4(f) against the retailer, claiming that any defect in the rope was caused by him, and against the decedent's employer, claiming he failed to provide the decedent, a painter, with a safe place to work.[37] The court saw *Coleman* as settling the validity of Rule 4(f), regardless of the subject matter jurisdiction. It saw no constitutional problem, given *Hanna v. Plumer*[38] and the availability of nationwide service of process in interpleader cases.

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[35]The Reporter to the Advisory Committee in his Memorandum on Comments to Rule 4 relied on the statutory service provisions of the stockholder's derivative suit, 28 U.S.C. § 1695 (1970), and interpleader, 28 U.S.C. § 2361 (1970). *See* Vestal, *Expanding the Jurisdictional Reach of the Federal Courts: The 1963 Changes in Federal Rule 4*, 38 N.Y.U. L. REV. 1053, 1061 (1963).

[36]49 F.R.D. 63 (D. Md. 1969).

[37]The typical fact situation under Rule 14 would be the obverse of this one, the "vouching in" by an insured against his insurer, an employer against his employee or a retailer against a distributor or manufacturer, when there is a duty of indemnification. Notice may cross state lines and the prior judgment is given collateral estoppel effect against the vouchee. In these cases, as with warranty, there is no personal jurisdiction over the absent vouchee. Rather it is his pre-existing duty to indemnify that binds the vouchee subsequently.

[38]380 U.S. 460 (1965). An executor in a diversity case was served by leaving copies of the summons and complaint at his home with his wife pursuant to F.R.C.P. (4)(d)(1) rather than in hand as required by state law. The Court held the Rule was within the Enabling Act and without the Erie rule. For a discussion on whether these are mutually exclusive categories see: Chayes, *Some Further Last Words on Erie: The Bead Game*, 87 HARV. L. REV. 741 (1974); Ely, *The Irrepressible Myth of Erie*, 87 HARV. L. REV. 693 (1974); Ely, *The Necklace*, 87 HARV. L. REV. 753 (1974). *Hanna* does not hold anything arguably procedural is therefore constitutional. Reliance on it in *Pierce* begs the question.

Pierce is the only case to squarely raise the issue of the *power* of the federal government to provide for service across state lines. It did not consider limitations based on fundamental fairness, but in that regard the third party defendants were Pennsylvanians who could have been made to travel much farther than 100 miles within the state, to a place far less convenient, such as Pittsburgh, rather than to Baltimore, Maryland.

C. Class Actions

A third area of potential extraterritorial effect in diversity jurisdiction is found in class actions, in particular the 1966 amendments affecting the "spurious" class provisions of Federal Rule 23(b)(2) and (3). The Advisory Committee's Notes observed of the old rule that, "[T]he judgments in 'true' and 'hybrid' class actions would extend to the class (although in somewhat different ways); the judgment in a 'spurious' class action would extend only to the parties, including the intervenors."[39] The new rule binds the members of the "spurious" class who have been given notice and who do not request exclusions.

The binding effect of class action judgments on absent nonparties was early challenged and confirmed. In *Smith v. Swormstedt*[40] the Court held: "The legal and equitable rights and liabilities of all being before the court by representation, and especially where the subject matter of the suit is common to all, there can be very little danger but that the interest of all will be properly protected and maintained."[41] Not only were the plaintiffs representing a class, but the defendants were being sued as a class. The dispute was between the southern and northern travelling ministers of the Methodist Episcopal Church over a fund and property in Cincinnati held by an unincorporated body politic in Ohio also named as a defendant. The action was filed in Ohio, where all the property in dispute was located. *Supreme Tribe of Ben Hur v. Cauble*[42] was similar, involving a class action by representatives of Class A certificate owners brought in Indiana concerning the power of a fraternal benefit association organized under Indiana law to create Class B benefits, allegedly diluting the Class A benefits.

The importance of the in rem-in personam distinction and its applicability to class actions seemed immaterial until *Christopher v.*

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[39]FED. R. CIV. P. 17 to 23.2.

[40]57 U.S. (16 How.) 288 (1853). The class action was deemed an equitable remedy. There appears to have been no challenge to any extraterritorial impact of such remedies raised in a state court.

[41]*Id.* at 303.

[42] 255 U.S. 356 (1921).

Brusselback.[43] An Illinois federal court judgment levying an assessment upon stockholders of an insolvent federal joint stock land bank located there was held *not* to be res judicata to Ohio stockholders. The Supreme Court ruled that mere membership in the corporation (class) was not consent to jurisdiction for in personam liability under the facts of the case, although otherwise, "[I]t is enough that in every case the stockholder has assumed or retained his membership in the corporation after the warning of the statute, or of rules governing the corporation, of which he knew or had opportunity to know, that the benefits of membership carry with them the risk that the corporation may stand in judgment for him."[44] The Court referred to the class action provisions as preserving "unimpaired the jurisdiction of Federal courts of equity in a class suit to render a decree binding upon absent defendants *affecting their interest in property within the jurisdiction* of the court."[45]

Recent cases, however, have focused rather on the issue of the adequacy of representation[46] and this concern seems an echo of the statement in *Smith v. Swarmstedt* quoted above.[47] The modern impetus for this is found in *Hansberry v. Lee*,[48] a case ironic because

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[43]302 U.S. 500 (1938).

[44]*Id.* at 504.

[45]*Id.* at 505 (emphasis added).

[46]*See* Note, *Collateral Attack on the Binding Effect of Class Action Judgments*, 87 HARV. L. REV. 589 (1974). Adequacy of representation does not eliminate the need for notice. Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 176-77 (1974).

[47]*See* text accompanying note 40 *supra*.

[48]311 U.S. 32 (1940). The theoretical justification of protection through adequacy of representation may be undercut by the line of cases beginning with Fuentes v. Shevin, 407 U.S. 67 (1972), in which the Court rejected the argument that no prior hearing was needed if substantive rights could be protected through subsequent return of property and award of damages. The Court noted that while due process tolerates some variance in form of the hearing appropriate to the nature of the case, the opportunity for a hearing must exist. There was no suggestion that the forum should be anything other than one with competent jurisdiction. Under Federal Rule 23(c)(2), requiring the absent party to request exclusion imposes no great burden. The absent party is not entitled to actual notice, however, but only "the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort." This language is taken from Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950). *See* Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 173-74 (1974). The Court in *Mullane* assumed that notice would not, and was not calculated to, come to the attention of all persons with an interest in the common trust fund for which an accounting was sought. To the argument that the proceeding was in personam the Court responded:

> The legal recognition and rise in economic importance of incorporeal or intangible forms of property have upset the ancient simplicity of property law and the clarity of its distinctions, while new forms of proceedings have confused the old procedural classification.
>
> But in any event we think that the requirements of the Fourteenth Amendment to the Federal Constitution do not depend upon a classification

that binding effect was denied, although it could have been granted had the first case proceeded explicitly on an in rem basis rather than as a class action. The controversy concerned a large area in Chicago subject to racially restrictive agreements entered into by some 500 landowners, which was to become effective when signed by owners of ninety-five percent of the frontage. A class action was brought to enforce it and the parties stipulated that the ninety-five percent requirement had been met. In a subsequent suit to enforce the agreement, the trial court found that owners of only fifty-four percent had signed the agreement, but that the issue was res judicata because of the prior class action. The Supreme Court of Illinois reversed and was affirmed by the United States Supreme Court which said:

> Those who sought to secure its benefits by enforcing it could not be said to be in the same class with or represent those whose interest was in resisting performance, for the agreement by its terms imposes obligations and confers rights on the owner of each plot of land who signs it. If those who thus seek to secure the benefits of the agreement were rightly regarded by the state supreme court as constituting a class, it is evident that those signers or their successors who are interested in challenging the validity of the agreement and resisting its performance are not of the same class in the sense that their interests are identical so that any group who had elected to enforce rights conferred by the agreement could be

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for which the standards are so elusive and confused generally and which, being primarily for state courts to define, may and do vary from state to state. Without disparaging the usefulness of distinctions between actions in rem and those in personam in many branches of the law, or in other issues, or the reasoning which underlies them, we do not rest the power of the state to resort to constructive service in this proceeding upon how its courts or this Court may regard this historic antithesis. It is sufficient to observe that, whatever the technical definition of its chosen procedure, the interest of the state in providing means to close trusts that *exist by the grace of its laws* and are administered under the supervision of its courts is so insistent and rooted in custom as to establish beyond doubt the right of its courts to determine the interests of all claimants, resident or nonresident, provided its procedure accords full opportunity to appear and be heard.

399 U.S. at 312-13 (emphasis added). But this power of the state, whether proceeding under an "in rem" label or not, to adjudicate the interests of nonresidents in a trust fund admittedly situated there, or against the trustee who owes his legal status to the laws of that state, involves no intrusion on the territorial sovereignty of another state. The same cannot necessarily be said of the state's power to adjudicate the rights or liabilities of a nonresident in a spurious class action. The common questions of fact or law in such a class action do not exist by grace of the federal law. The federal interest in adjudicating them is not the same as New York's in *Mullane.*

said to be acting in the interest of any others who were free to deny its obligation.[49]

There are apparently no cases which successfully impose in personam liability on an absent class defendant. Cases under Federal Rule 23 in which absent plaintiffs have been bound by an adverse "spurious" class action judgment — in which only their interests in a chose in action or a cause of action were cut off—have not yet been based on diversity jurisdiction.[50] The fact that an absent plaintiff might not be bound before the 1966 amendments led one defendant to argue that an absent class plaintiff ought not take advantage of a successful class action. This "mutuality" argument was rejected in that instance, since the plaintiff was in fact a party to the original action.[51]

D. Interpleader

It is natural that the ALI proposal should rely heavily on the

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[49]311 U.S. at 44. For a recent discussion of adequacy of representation, see Gonzales v. Cassidy, 474 F.2d 67 (5th Cir. 1973), holding that failure to appeal is not adequate representation if the representative was given retroactive benefits and the rest of the class was not. The case was a class action by drivers with suspended licenses, brought under Federal Rule 23(b)(2), seeking a declaratory judgment on the validity of a state's law on financial responsibility for motorists involved in accidents. It was governed by the intervening decision in Bell v. Burson, 402 U.S. 535 (1971). Although only implicit in the quotation in note 48 *supra*, it has been held that determination of adequacy of representation made prior to certifying the class is not binding on absent class members and may be challenged in a collateral proceeding. Research Corp. v. Edward J. Funk & Sons Co., 15 Fed. Rules Serv. 2d 580 (N.D. Ind. 1971).

[50]In re Four Seasons Securities Laws Litigation, Arthur Anderson & Co. v. Ohio, 502 F.2d 834 (10th Cir. 1974), and Phillips v. Clark, 525 F.2d 500 (10th Cir. 1975), denying relief under Federal Rule 60(b), which would have permitted absent plaintiffs to opt out after settlement. The court concluded they could have opted out earlier and that the representation leading to a settlement in retrospect was adequate. There are apparently no cases involving a challenge to the binding effect of a class action by an absent member who did not have the right to opt out. In National Student Market Litigation v. Barnes Plaintiffs, 530 F.2d 1012 (D.C. Cir. 1976) there was a failure of proof by the moving class members that they had not received notice. Another situation in which an absent party can be bound is found in Federal Rule 19(a), providing that a person needed for a just adjudication who is beyond the reach of process can be joined as an involuntary plaintiff in a "proper case." Such cases are those in which there is a pre-existing duty to permit the name to be used as a plaintiff and the situation is similar to the vouching in or warranty situation discussed in note 37 *supra*. *See* Independent Wireless Tel. Co. v. R.C.A., 269 U.S. 459 (1926).

[51]Schrader v. Selective Serv. Sys. Local Bd. No. 76, 329 F. Supp. 966 (W.D. Wis. 1971), *rev'd on other grounds*, 470 F.2d 73 (7th Cir.), *cert. denied*, 409 U.S. 1085 (1972).

provision for nationwide service of process in statutory interpleader cases.[52] It is a widely used provision of long standing.[53]

The nature of jurisdiction in interpleader has been the subject of dispute in the lower federal courts, notwithstanding the lack of challenge to nationwide service of process in those cases reaching the Supreme Court.[54] There is disagreement whether jurisdiction is in rem, quasi in rem, or in personam. The matter becomes critical if there are cross-claims.

Assume *A*, *B* and *C* were all residents of California. *A* owns a yacht and hires *B* to repair it for him for $15,000, to be held in escrow by *C* pending successful completion of the work. *A* moves to Maine and *B* to Hawaii. *C*, while visiting his friend *A* in Maine, is told that the work was not successfully completed. *B* informs *C* the work is done and demands the money. *C* files an interpleader action in the United States District Court for the District of Maine,[55] depositing the $15,000 with the court and serving *A* in Maine and *B* in Hawaii. *A*, alleging that the work was not performed, files a counterclaim for the fund and, alleging $50,000 damage by virtue of *B*'s work on the boat, cross-claims against *B*.[56]

Plainly a Maine state court could not give judgment against *B* for the alleged damage to the boat if he does not submit to the court's jurisdiction. However, the statutes and rules contemplate that the

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[52]28 U.S.C. § 2361 (1970) provides that in interpleader actions brought under section 1335 of that title "a district court may issue its process for all claimants and enter its order restraining them from instituting or prosecuting any proceeding in any State or United States Court affecting the property, instrument or obligation . . . until further order . . . ."

[53]First adopted in 1917, 39 Stat. 929, it antedates 28 U.S.C. § 1695 (1970), covering stockholder's derivative actions, adopted April 16, 1936, ch. 230, 49 Stat. 1213. There is yet another statutory provision having effect across state lines, 28 U.S.C. § 1404(a) (1970), adopted June 25, 1948, ch. 646, 62 Stat. 937, providing for a change of venue. It is similar to 28 U.S.C. § 1406(a) (1970), providing for transfer to a jurisdiction where the action could have been brought in order to cure improper venue, in that the transferee court has personal jurisdiction over the defendant, and the transferor court does not. Hoffman v. Blaski, 363 U.S. 335 (1960). Section 1406(a) differs from section 1404(a) in that the defendant may move under section 1404(a) to transfer the case even when venue is proper, forcing the plaintiff to try the case in a district where *plaintiff* is not subject to service of process. *See* Van Dusen v. Barrack, 376 U.S. 612 (1964). Apparently no plaintiff, on defendant's section 1404(a) motion, has objected to the court's powers.

[54]*See* notes 17-21 *supra.*

[55]Venue is set where a claimant resides. 28 U.S.C. § 1397 (1970).

[56]The pertinent language of Federal Rule 13(g) is "arising out of the transaction or occurrence . . . or relating to any property that is the subject of the original action." Clearly if there were no escrow arrangement and the suit was only between *A* and *B* the counterclaim would be compulsory as arising out of the "transaction or occurrence" within the meaning of Federal Rule 13(a). *See* 6 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1410 (1969).

United States District Court sitting in diversity may do so.[57] The jurisdiction of the cross-claim is ancillary, which supplies the basis for subject matter jurisdiction. Is it a basis for personal jurisdiction in the federal court?

The nature of the court's jurisdiction over the claimants in an interpleader action should be viewed as a product of the nature of an interpleader action. Conventional wisdom, if not received knowledge, had it that the *relief* afforded by interpleader was essentially in personam although the basis of the jurisdiction was essentially in rem, whether reference was to the original "strict" bill in interpleader on the law side or the bill in the nature of a bill in interpleader on the equity side. The latter was clearly a device of the Chancellor. The origin of the former is a matter of some dispute, although relief is always the discharge of the stakeholder-plaintiff from personal liability upon the deposit of payment into court. Then the claimants, "enjoined" from suing the stakeholder-plaintiff, fight it out among themselves in the "second stage." Whether the first stage is viewed as giving essentially legal or equitable relief, there were four strict requirements:

> The equitable remedy of interpleader . . . depends upon and requires the existence of the following conditions: 1. The same thing, debt, or duty must be claimed by both or all the parties against whom the relief is demanded. 2. All the adverse titles or claims must be dependent. 3. The person asking relief—the plaintiff—must not have any claim or interest in the subject matter. 4. He must have incurred no independent liability to either of the claimants; that is, he must stand perfectly indifferent between them, in the position merely of a stakeholder.[58]

Equity's development of a bill in the nature of a bill in interpleader gave relief when the stakeholder violated the third requirement by claiming an interest in the subject matter and when there was some basis for equitable relief other than the possibility of multiple liability or inconsistent judgments.[59] Even if the first stage of strict

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[57] *But see* Marine Bank & Trust Co. v. Hamilton Bros., Inc., 55 F.R.D. 505 (W.D. Fla. 1972), discussed in note 88 *infra*.

[58] J. POMEROY, EQUITY JURISPRUDENCE § 1322 (1883).

[59]

> A bill in the nature of a bill of interpleader is one in which the complainant seeks some relief of an equitable nature concerning the fund or other subject-matter in dispute, in addition to the interpleader of conflicting claimants. The complainant is not required, as in strict interpleader, to be indifferent stakeholder, without interest in the subject-matter. It is essential, however, that the facts on which he relies entitle him to equitable, as distinguished from legal, relief; he is not permitted, under the guise of a bill in equity, to

interpleader gave an equitable remedy that involved the in personam relief of an injunction against the claimant-defendants suing the discharged stakeholder-plaintiff for the res, the original basis of jurisdiction is seen to be in rem. Relief in the first stage of strict interpleader, even if viewed as equitable, nonetheless had as its ancestor common law interpleader, used in a "real" or in rem action like detinue.[60]

Whatever the original requirements of interpleader,[61] Pomeroy's four requirements were contained in the original federal statute. They were, however, much modified by subsequent amendments.[62] These changes were due almost entirely to the writing of Professor Zechariah Chafee, Jr., who drafted the 1936 amendments.[63] Presently the first three of Pomeroy's requirements are expressly abolished under both statutory and Rule[64] interpleader.[65] The ability

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litigate a purely legal claim or interest in the subject-matter . . . . J. POMEROY, EQUITY JURISPRUDENCE § 1481 (4th ed. 1919).

[60]There is a view that no writ of interpleader was available at common law, but that it was available only as a defensive measure. *See* Rogers, *Historical Origins of Interpleader*, 51 YALE L.J. 924 (1942). Plainly it was available in response to detinue actions brought by several claimants to lost goods casually found, or to a bailee given goods to be delivered to a third person upon the happening of a certain event.

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> 1. The "classic" requirements for interpleader are not in any proper sense classic but are in fact of fairly late origin in the history of equitable jurisdiction.
> 2. The four requirements for interpleader stated by Pomeroy originated in the improvisations *ad hoc* and achieved generalization and authority by virtue of credulous extensions of precedent.
> 3. Of the four requirements, one—the requirement that the claimants' titles be "derivative" or from a "common source" — is plainly insupportable; another — that the stakeholder not dispute the extent of his liability — is the subject of divided authority concealed by the suppositious "bill in the nature of interpleader"; another — that the stakeholder have no "independent liability" to either claimant — was a response to a now obsolete procedural difficulty; and the remaining one — that the claims relate to "the same debt or duty" — is question-begging.

Hazard & Moskovitz, *An Historical and Critical Analysis of Interpleader*, 52 CAL. L. REV. 706, 749-50 (1964).

[62]39 Stat. 929 (1917); 43 Stat. 976 (1925); 44 Stat. 416 (1926); 49 Stat. 1096 (1936).

[63]Professor Chafee's writings include: *Modernizing Interpleader*, 30 YALE L.J. 814 (1921); *Interstate Interpleader*, 33 YALE L.J. 685 (1924); *Interpleader in the United States Courts*, 41 YALE L.J. 1134 (1932), 42 YALE L.J. 41 (1932); *Federal Interpleader Bill: Draft and Memorandum*, prepared for the Section on Insurance Law of the American Bar Association (May 1934); *The Federal Interpleader Act of 1936*, 45 YALE L.J. 963, 1161 (1936); *Federal Interpleader Since the Act of 1936*, 49 YALE L.J. 377 (1940); *Broadening the Second Stage of Interpleader*, 56 HARV. L. REV. 541, 929 (1943).

[64]Federal Rule 22 interpleader is not part of the present discussion, since it contemplates personal service under Federal Rule 4, and not service across state lines.

[65]*Developments in the Law: Multiparty Litigation in the Federal Courts*, 71 HARV. L. REV. 875, 926-27 (1958).

to file counterclaims under Federal Rule 13 would seem to eliminate the fourth requirement of no independent liability.[66] Federal interpleader today seems to contemplate relief when jurisdiction cannot be viewed as either in rem or quasi in rem. This may not be the case and therefore such actions might be maintainable in state courts. It was, however, failure of relief in a state court that led to adoption of the federal statute in the first place. That failure should be reviewed before turning to the current disputes on the nature of interpleader jurisdiction in the lower federal courts and the possibility of cross-claims between absent claimants.

The case is, of course, *New York Life Insurance Co. v. Dunlevy*[67] and the failure or refusal of the Court to apply the quasi in rem jurisdictional base of *Harris v. Balk*.[68] The difficulty flows both from the problem of locating the situs of intangible property and the fictitious ubiquity of corporations. The issue for our purposes is whether *Mullane*[69] will permit the reification and localization of such property so that a court can give in rem or quasi in rem judgments even though the property holder may be in more than one territorial jurisdiction at any one time. The answer seems to be "yes."

In *Harris* the property was an admitted debt which was attached by the civil arrest of the debtor by a creditor of the creditor. This asset was in effect reified by the debtor's admitting the debt and depositing a bond as a condition for his release. The debtor then notified, but did not serve, his creditor in another state. In a subsequent suit by that creditor against the debtor in the other state,

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[66]The proper historical conception of interpleader has been stated thusly:

> A person against whom two or more persons make claim may bring an action for determination whether he is liable to one or several of the claimants, and if so to what extent, whenever:
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> (a) the claims involve contentions of fact, or contentions of mixed law and fact, such that the plaintiff may sustain double or multiple liability as a consequence of the contentions being determined inconsistently; or
>
> (b) the claims may exhaust a limited fund to which the claimants look for recovery.

Hazard & Moskovitz, *supra* note 61, at 762-63.

[67]New York Life Ins. Co. v. Dunlevy, 241 U.S. 518 (1916).

[68]198 U.S. 215 (1905). Notwithstanding *Harris*, the Third Circuit recently declared quasi in rem jurisdiction unconstitutional on the basis of Fuentes v. Shevin, 407 U.S. 67 (1972), apparently even as a means of establishing jurisdiction when the res would not be restrained after appearance. Jonnet v. Dollar Savings Bank, 530 F.2d 1123 (3d Cir. 1976). Judge Gibbons concurred on the ground that the minimum contacts test of International Shoe Co. v. Washington, 326 U.S. 310 (1945) for personal jurisdiction applies also to quasi in rem jurisdiction and thus limits *Harris*. Subsequently another panel invalidated the Delaware sequestration procedure on the latter ground. U.S. Industries, Inc. v. Gregg, 540 F.2d 142 (3d Cir. 1976). A broad array of challenges to that procedure, which does not permit a special or limited appearance, is presented in Greyhound Corp. v. Heitner, 361 A.2d 225 (Del. 1976), *appeal filed sub nom.* Shaffer v. Heitner, 45 U.S.L.W. 3004 (June 15, 1976) (No. 75-1812).

[69]*See* quotation in note 48 *supra*.

the Supreme Court held the defendant could plead his deposit in the first suit as a defense, since he had given notice. The practical effect was to hold that the original obligation has a situs where the debtor was and, when attached, could be treated like a res for jurisdictional purposes.[70]

In *Dunlevy* the debtor did not admit its liability to anyone in particular, but only that it owed the sum to one of two claimants, not knowing which because of a disputed assignment.[71] Here again the nonresident claimant was given notice but not served. Here, however, that claimant was allowed to prevail in the second suit and the debtor was not permitted to plead the deposit in court in an interpleader action in the first state or that the property had been awarded to the other claimant.[72] The holding seems to indicate that if the stakeholder does not admit the property belongs to the absent claimant, or the court does not so adjudicate, there is nothing of the nonresident's in the state over which to extend quasi in rem jurisdiction, thus leaving the absent claimant with notice free to argue later that there was.

This distinction has been advanced more formally in *Atkinson v. Superior Court*[73] in which Justice Traynor said *Dunlevy* was an interpleader action initiated by the stakeholder, whereas *Harris* was garnishment or attachment. The former involved a disputed claim, the latter an undisputed claim. In *Atkinson* the question was

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[70]Note that the attaching creditor was not claiming title to or an existing right to immediate possession in the thing attached. At common law the writ of garnishment was closely related to interpleader, but was allowed only in an action for detinue, involving chattels real. There the defendant could garnish or call in a third party who also had a claim. The writ of *scire facias* would issue against the third party, who then became the defendant in the detinue action, with the garnishee out of court discharged from further liability.

[71]The debtor was a corporation doing business in more than one state. Nothing was made to turn on the potential problem of deciding in which state the debt would be located if the *Harris* rule of the debt following the debtor were to be applied to such corporations. The case was decided as though the debtor were an individual.

[72]As the caption suggests, the stakeholder-debtor was an insurance company. The 1917 Act, 39 Stat. 929, authorized filing of interpleader by "any insurance company or fraternal benefit society." The 1925 amendment, 43 Stat. 976, expanded this to "any insurance company or association or fraternal or beneficial society." The 1926 amendment, 44 Stat. 416, added casualty companies and surety companies. The final changes in 1936, 49 Stat. 1096, include "any person, corporation, association, or society" and added relief in the form of a bill in the nature of a bill in interpleader. The Act always required a deposit or bond. Federal Rule 22 interpleader does not expressly require deposit or bond. *See* Urborn, *Multiple Claims from One Accident: Federal Interpleader*, 34 INS. COUNSEL J. 343 (1967), urging this benefit of Rule interpleader. However, Rule interpleader requires in personam jurisdiction in the first instance, and in any event, the court has discretion in requiring deposit or bond. *See* United States v. Coumantaros, 146 F. Supp. 51 (S.D.N.Y. 1956).

[73]49 Cal. 2d 338, 316 P.2d 960 (1957).

whether New York trustees were indispensible parties to a California class action brought by California employees against California employers to decide whether certain royalties were wages so that their diversion to New York trusts would be in violation of a collective bargaining agreement. The employers alleged their willingness to pay the royalties as wages, but alleged the conflicting demands of the New York trustees. The court held that since the case was not one of the stakeholder invoking the jurisdiction of a court remote from the claimant for the purpose of terminating his obligation, or one where the stakeholder seeks to have conflicting claimants adjudicate their rights in a forum of his own choice, the court could find no distinction between quasi in rem jurisdiction over a nonresident's chose in action admittedly his and jurisdiction to establish that it was never his.[74] The court found the minimum contacts required by due process satisfied.[75]

Statutory interpleader was intended to overcome the *Dunlevy* problem[76] and as noted above[77] this has apparently been successful. While no direct challenge to nationwide services of process was made in the Supreme Court in *State Farm Fire and Casualty Co. v.*

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[74]The situs of the chose in action as California was not challenged. When the stakeholder is a corporation present in more than one state, unless the obligation can be reified and localized, no one state has exclusive territorial jurisdiction to foreclose the interest of nonresident claimants without infringing on the sovereignty of another state. *See* Western Union Tel. Co. v. Pennsylvania, 368 U.S. 71 (1961), discussed in note 94 *infra*. In Steele v. G.D. Searle & Co., 483 F.2d 339 (5th Cir. 1973), the court treated the problem of locating the situs of the debt of a multi-state corporation (admittedly generally present) in a manner similar to locating the corporate presence by evaluating the contacts with the state of the transaction giving rise to the debt.

[75]For a general discussion of the impact of Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950), on the problem, *see* Hazard, *A General Theory of State Court Jurisdiction*, 1965 SUP. CT. REV. 241, 281-88, and von Mehren & Trautman, *Jurisdiction to Adjudicate: A Suggested Analysis*, 79 HARV. L. REV. 1121 (1966). The "minimum contacts" theory has been the subject of a great deal of commentary. *See, e.g.*, Comment, *Jurisdiction in Rem and the Attachment of Intangibles: Erosion of the Power Theory*, 1968 DUKE L.J. 725. It has been suggested that full faith and credit rather than due process is the proper focus where subsequent impact on nonresidents is involved. Pennoyer v. Neff, 95 U.S. 714 (1877), is blamed for equating full faith and credit with due process and then focusing on due process alone. *See* Comment, *Long Arm and Quasi In Rem Jurisdiction and the Fundamental Test of Fairness*, 69 MICH. L. REV. 300, 305 (1970).

[76]*See* Sanders v. Armour Fertilizer Works, 292 U.S. 190 (1934). Note that in statutory interpleader the concerns expressed by Justice Traynor in *Atkinson* would be expressed in terms of venue in the federal courts. In any event, the distinction between permitting a claimant to reify the debt, but not permitting the stakeholder to reify it where another claimant is located, is elusive at best.

[77]*See* cases cited at notes 18-21 *supra*. Since no challenge has been made in the Supreme Court, there has been no occasion to pass on the jurisdictional consequences of the amendments cited in note 62 *supra*.

Tashire,[78] such a challenge was made below but expressly was not passed on.[79] The Ninth Circuit ruled that claimants with unliquidated tort claims were not claimants within the meaning of section 1335,[80] and on this point the Supreme Court reversed. While holding that interpleader jurisdiction was properly invoked, the Supreme Court ruled that the injunction affecting the second stage was improper, thus avoiding the issue. The language used, however, recognized the traditional distinction between in rem or quasi in rem in the first stage proceeding, and personal jurisdiction in the second stage.[81]

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[78]386 U.S. 523 (1967).

[79]Tashire v. State Farm Fire & Cas. Co., 363 F.2d 7 (9th Cir. 1966).

[80]The case went to the circuit court on an interlocutory appeal from the grant of a preliminary injunction. 28 U.S.C. § 1292(a)(1) (1970). The action was commenced in the United States District Court for the District of Oregon, where a potential claimant, a passenger in a truck, resided. The plaintiff, insurer of the truck driver which collided with a Greyhound bus in California, deposited the full limits of the policy in court in Oregon. Injured bus passengers, including both Canadians and Americans, had already instituted actions in California, claiming more than $1,000,000 in damages. Plaintiff insurer sought a declaration of no coverage and, in the alternative, a discharge from liability beyond the policy limits already deposited. In addition, the insurer sought discharge from the duty to defend the truck driver and an order requiring all claimants to establish liability in the Oregon proceeding and no other. A preliminary injunction against the nonresident claimants prosecuting their claims elsewhere was issued, and later was broadened at Greyhound's request to include suits against it and its driver.

[81]386 U.S. 533-34.

> The fact that State Farm had properly invoked the interpleader jurisdiction under § 1335 did not, however, entitle it to an order both enjoining prosecution of suits against it outside the confines of the interpleader proceeding and also extending such protection to its insured, the alleged tortfeasor. Still less was Greyhound Lines entitled to have that order expanded so as to protect itself and its driver, also alleged to be tortfeasors, from suits brought by its passengers in various state or federal courts. Here, the scope of the litigation, in terms of parties and claims, was vastly more extensive than the confines of the "fund," the deposited proceeds of the insurance policy. In these circumstances, the mere existence of such a fund cannot, by use of interpleader, be employed to accomplish purposes that exceed the needs of orderly *contest with respect to the fund.*
>
> There are situations, of a type not present here, where the effect of interpleader is to confine the total litigation to a single forum and proceeding. One such case is where a stakeholder, faced with rival claims to the fund itself, acknowledges—or denies—his liability to one or the other of the claimants. In this situation, the fund itself is the target of the claimants. It marks the outer limits of the controversy. It is therefore, reasonable and sensible that interpleader, in discharge of its office to protect the fund, should also protect the stakeholder from vexatious and multiple litigation. In this context, the suits sought to be enjoined are squarely within the language of 28 U.S.C. § 2361 . . . .

(footnote omitted) (emphasis added).

Lower federal courts have often recognized the difference between the nature of the jurisdiction and the nature of the relief as between the first and second stages. It has been said that the relief to the stakeholder is not in rem,[82] and that the jurisdiction is neither in rem nor in personam.[83] The relief to the stakeholder against and among the claimants has been to adjudicate only the interest in the res.

There is no case imposing personal liability on a claimant "personally served" under nationwide service when that claimant was not otherwise subject to personal jurisdiction, such as by entering an appearance or filing a counterclaim. The only holdings are to the contrary. In *Hallin v. C.A. Pearson, Inc.*[84] the court, in denying a cross-claim, summarized the law as follows:

> It has been held that one defendant-claimant in such an interpleader action may not assert an in personam cross-claim against another defendant-claimant, who is a non-resident of the state in which the action is brought and thus not otherwise subject to process, where the non-resident defendant, although served, did not appear in the action to assert any claim to the interpleader fund. Stitzel-Weller Distillery v. Norman, 39 F.Supp. 182 (W.D.Ky. 1941); Hagan

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[82]"The payment of the amount of the debt into court does not make interpleader a proceeding *in rem*, but it is merely a condition precedent to relief from double vexation . . . ." Chafee, *Interstate Interpleader*, 33 YALE L.J. 685, 711 (1924). *See* Humble Oil & Ref. Co. v. Copeland, 398 F.2d 364 (4th Cir. 1968) and Commercial Security Bank v. Walker Bank & Trust Co., 456 F.2d 1352 (10th Cir. 1972). In Knoll v. Socony Mobil Oil Co., 369 F.2d 425 (10th Cir. 1966), the court stated it had *no jurisdiction* to enjoin the claimants from making other claims elsewhere with reference to the same transaction. It stated its jurisdiction was in personam only as to the fund. The case is a strong one, for it does not appear that nationwide service of process was availed of, and in any event the claimants had already filed a counterclaim for the fund, thus arguably submitting themselves to jurisdiction of the court. It is not clear whether the court was referring to subject matter jurisdiction or personal jurisdiction. In this regard the relief requested was not dissimilar from that disallowed in *Tashire*. *See* notes 80 & 81 *supra*.

[83]United States v. Coumantaros, 146 F. Supp. 51 (S.D.N.Y. 1956); Metropolitan Life Ins. Co. v. Skov, 45 F. Supp. 140 (D. Ore. 1942). *See also* Traynor, *Is This Conflict Really Necessary*, 37 TEX. L. REV. 657, 663 (1959), urging complete elimination of the distinction between in rem and in personam actions. Compare Aetna Life Ins. Co. v. DuRoure, 123 F. Supp. 736 (S.D.N.Y. 1954), in which the claimants were nationals of France and the United States. Claimants sought interest on the theory plaintiff unreasonably delayed paying the fund into court. The court held the delay justified because the French claimants did not come to the United States until shortly before the interpleader action and the teaching of *Dunlevy* prevented the stakeholder from converting its personal obligation into an in rem proceeding by depositing the sum into court. While the court stated in personam jurisdiction was needed over the claimants, it is not clear that it meant the kind of jurisdiction necessary to impose liability.

[84]34 F.R.D. 499 (N.D. Cal. 1963).

> v. Central Avenue Dairy, 180 F.2d. 502, 17 A.L.R.2d 735 (9th Cir. 1950); Great Lakes Auto Ins. v. Shepherd, 95 F.Supp. 1 (W.D.Ark. 1951).
>
> It has also been held, however, that in such case an appearing defendant-claimant, against whom an in personam cross-claim has been asserted by another appearing defendant-claimant may waive any objection which it might otherwise have had thereto. Coastal Air Lines v. Dockery, 180 F.2d 874 (8th Cir. 1950).[85]

Subsequent cases have cited *Hallin* and followed it.[86] To the argument that the court *must* entertain the cross-claim because it arises out of the same "transaction or occurrence"[87] the only court specifically addressing itself to that issue said the rule's application would run counter to the policy of Congress of encouraging adverse claimants to come and assert their interests in the interpleaded property, and it should not be used as a tool to expand jurisdiction over nonresidents.[88]

IV. Justification Other Than Nationwide Service of Process

The ALI proposals for extending diversity jurisdiction to the multi-state, multi-party situation are bottomed on the broad principle of the availability of nationwide service of process in diversity cases. While the Supreme Court in dicta has said such was permissible, there is only one case upholding the imposition of liability when the issue was squarely raised, and that was in a district court.[89] In all other cases the courts disclaimed jurisdiction to impose personal liability on the nonresident defendant.[90] In other words,

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[85]*Id.* at 501-02. The *Shepherd* case, ironically, is the one relied on by the ALI in its Supporting Memorandum B. See note 14 *supra.*

[86]Mahaney v. Doering, 260 F. Supp. 1006 (E.D. Pa. 1966); Marine Bank & Trust Co. v. Hamilton Bros., 55 F.R.D. 505 (M.D. Fla. 1972).

[87]Fed R. Civ. P. 13(g).

[88]Marine Bank & Trust Co. v. Hamilton Bros., 55 F.R.D. at 507. The interpleaded fund was a $15,000 escrow account to be paid a nonresident claimant on completion of successful repairs to the second claimant's boat. The second claimant's cross-claim of $50,000 for damages to the boat was disallowed. Only one case has allowed a cross-claim, Bank of Neosho v. Colcord, 8 F.R.D. 621 (W.D. Mo. 1949), but that was a proceeding under Rule 22 interpleader in which there was already in personam jurisdiction, since personal service of the claimants must have been made under Federal Rule 4. Because of the lower jurisdictional amount and the necessity of only minimal diversity, State Farm Fire & Cas. Co. v. Tashire, 386 U.S. 523, the only procedural advantage of Rule interpleader is the availability of cross-claims. However, in Preferred Risk Mut. Ins. Co. v. Greer, 289 F. Supp. 261 (D.S.C. 1968) cross-claims in Rule interpleader were disallowed because the interpleader jurisdiction even there was held to be in rem.

[89]*See* text accompanying note 36 *supra.*

[90]*See* text accompanying notes 84-86 *supra.*

those situations which lend support to the legitimacy of nationwide service of process are those that bind absent plaintiffs, cases over which a state court could have exercised jurisdiction, through the devices of reifying a chose in action for quasi in rem jurisdiction, or of representation in the class action.[91] This latter assertion, of course, assumes *Dunlevy* does not survive and the limiting distinctions in *Atkinson* do not stand.

Another potential barrier to the exercise of state court jurisdiction is the other aspect of *Dunlevy* mentioned earlier: assuming the attachment of quasi in rem jurisdiction to the chose in action, where may that be accomplished when the debtor is a corporation present in many jurisdictions at once? Under statutory interpleader the stakeholder may locate it by depositing it in a federal court where a claimant is found. There may be some question whether a state court has that power. *Western Union Telegraph Co. v. Pennsylvania*[92] suggests the continuing validity of *Dunlevy* by focusing on the territorial nature of state sovereignty, and the state's inability under the due process clause in some circumstances to locate the situs of the res. Pennsylvania was attempting to escheat some unclaimed funds from undelivered and unreturned money orders in the hands of Western Union, some of which had already been escheated by New York. The Supreme Court said that since several states could claim in rem jurisdiction over the funds Pennsylvania did not have the *power* to protect Western Union from any other claim by another state since its judgment would not be entitled to full faith and credit as against those other claimant states.[93]

The same sort of problem would seem to be present under

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[91]*See also* Note, *Consumer Class Actions With a Multi-State Class: A Problem of Jurisdiction*, 25 HASTINGS L.J. 1411 (1974). Federal class actions do not purport to bind the absent members through personal service. The provision for service on the absent corporation under 28 U.S.C. § 1695 (1970) can also be viewed as permitting the minority stockholder to turn the corporation's potential claim into a chose in action for quasi in rem jurisdiction. Of similar effect is defendant's transfer under 28 U.S.C. § 1404(a) (1970).

[92]368 U.S. 71 (1961).

[93]Statutory interpleader would be unavailable to Western Union because of the eleventh amendment. *See* note 19 *supra*. The solution is to require an action by the claiming state in the original jurisdiction of the United States Supreme Court for a declaration of rights against other claiming states and the stakeholder. The Supreme Court has subsequently decided that the location of the res is at the last known address of the creditor, although it acknowledged that such a rule was not produced by "statutory or constitutional provisions or by past decisions, nor is it entirely one of logic. It is fundamentally a question of ease of administration and of equity." Texas v. New Jersey, 379 U.S. 674, 683 (1965). When there is no such address available, the state of incorporation of the stakeholder may escheat. Pennsylvania v. New York, 407 U.S. 206 (1972).

proceedings similar to that in *Seider v. Roth.*[94] That case arose from an accident in which a New Yorker was injured by a non-New Yorker whose liability carrier was doing business in New York. The insurance company's obligation to its insured was attached in New York as the quasi in rem jurisdictional base for adjudicating the New Yorker's claim against the non-New Yorker.[95] On the surface this judicially enacted direct action statute is like *Harris* and unlike *Dunlevy* in that the garnishee admits an obligation to an out of stater, albeit an inchoate or contingent one. However, the location of the obligation is problematical. The insurance company does business in more than one state and, unlike under statutory interpleader, has not attempted to reify the obligation by depositing a sum with the court. Suppose a Pennsylvanian was also injured in the same accident by the same insured and the insurance company was attached in Pennsylvania where it was also doing business. The New York Court of Appeals, in response to a due process challenge, merely cited *Harris* for the proposition that when there is in personam jurisdiction there is in rem jurisdiction.[96] Here, however, the eleventh amendment would be no bar to statutory interpleader by the insurance company.[97] The interest of no other state in its sovereign capacity would be infringed by permitting a state court to localize a chose in action in interpleader as federal courts sitting in diversity may do. The claimant to the fund never had a right to anticipate that the fund would be located or could be reified in his own state unless, of course, the fund is deemed located in the state where the accident took place. In that case both the insurance company and the insured—the alleged debtor of the claimant to the fund—would be subject to in personam jurisdiction there,[98] so quasi in rem jurisdiction would be unnecessary.

In any event, should *Dunlevy* remain a bar in state courts, provision for the reification and location of choses in action held by multi-state corporations can be made by Congress.[99] Other devices, without resort to nationwide service of process, could be employed.

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[94]17 N.Y.2d 111, 216 N.E.2d 312, 269 N.Y.S.2d 99 (1966).

[95]Watson v. Employers Liab. Assur. Corp., 348 U.S. 66 (1954) differs in that it was a choice of law case permitting Louisiana to enforce its direct action statute against an insurer qualified to do business in Louisiana for an accident occurring there, even though the contract of insurance had a "no action" clause valid under the law of the state where it was written.

[96]Simpson v. Loehmann, 21 N.Y.2d 305, 234 N.E.2d 669, 287 N.Y.S.2d 633 (1967). *Western Union* was not mentioned.

[97]Interpleader would not, however, force the Pennsylvanian to litigate liability in New York. *See* note 80 *supra.*

[98]Hess v. Pawloski, 274 U.S. 352 (1927).

[99]*See, e.g.,* Katzenbach v. McClung, 379 U.S. 294 (1964) (commerce clause) and Katzenbach v. Morgan, 384 U.S. 641 (1966) (fourteenth amendment). In some

Indeed, most of the cases granted transfer by the Panel on Multidistrict Litigation are those involving federal question jurisdiction in which Congress could grant nationwide service of process or in which a state could reach the case through use of its long arm.[100] The fact that a state might decline to extend personal jurisdiction as far as the due process clause would allow is no bar to authorizing a federal court sitting in diversity to do so.[101]

V. Conclusion

The American Law Institute has made a modest proposal for expansion in diversity jurisdiction that contemplates nationwide service of process imposing personal liability on defendants outside the forum district. Authority for such process is seen in the article III provision establishing the lower federal courts and vesting original diversity jurisdiction in them. Reliance is placed on Supreme Court dicta and two statutes so authorizing. These authorities involve actual or potential federal question jurisdiction, and situations in which a state court might exercise its power over absent parties through long arm or variants of in rem jurisdiction. Subsequent to the ALI proposal, various other practices and procedures have been authorized which lend colorable support to the existence of such power, but these, with one exception,[102] could similarly be provided for in state courts or under federal question jurisdiction. However,

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instances, but by no means all, a state might have the interest and the contacts to declare itself the situs. *See* Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950).

[100]As of January 10, 1974, there were 148 groups of multidistrict litigation in which transfer was granted, broken down into the following types:

Antitrust (35); Securities (28); Mass Disaster (28); Patent/Copyright (11); Products Liability (1); Contract (1); Environmental (2); Consumer Class Actions (1); Miscellaneous (5).

Note, *The Judicial Panel and the Conduct of Multidistrict Litigation*, 87 HARV. L. REV. 1001, 1003-04 (1974). Cases arising arguably outside the scope of the commerce clause, such as mass disasters or contracts, could be reached by a state long arm. If a state may reach a defendant because the cause of action arose there, why may it not reach a prospective plaintiff? *See* McCoid, *A Single Package for Multiparty Disputes*, 28 STAN. L. REV. 707 (1976). The "typical litigation situations" involving necessary parties under Rule 19 have been put under twelve headings in 7 C. WRIGHT & A. MILLER, FEDERAL PRACTICE AND PROCEDURE §§ 1613-24 (1972). They are:

Contracts (Joint obligations, Assignments, Partnership and Agency); Copyrights, Patents and Trademarks; Corporations and Shareholders; Declaratory Judgments; Federal, State and Local Governments; Funds, Property Rights, Trusts, and Estates; Insurance; Labor Management Relations; Real Property; Superior and Subordinate Public Officials; Torts and Workmen's Compensation; Miscellaneous Cases.

Again, it appears that the great bulk of these cases could be reached under federal question jurisdiction or by a state through a long arm or quasi in rem jurisdiction.

[101]Arrowsmith v. United Press Int'l, 320 F.2d 219 (2d Cir. 1963) (en banc).

[102]Pierce v. Globemaster Baltimore, Inc., 49 F.R.D. 63 (D. Md. 1969).

common to most of the situations is a "quasi" quasi in rem adjudication of the existing interests of absent plaintiffs. The imposition of liability on distant defendants, of concern to the ALI, raises questions about the source of the power so to act, as well as the issue of a fifth amendment due process limitation—a concern of lower federal courts which the proposal did not consider.[103] The ability of a court in Maine to impose liability on a defendant in California or Hawaii on a non-federal cause of action in which the defendant does not have sufficient minimal contacts with Maine to satisfy fourteenth amendment due process requirements suggests a basic reordering in federal-state relationship and individual rights.[104] While there may be only a very small number of defendants who could not otherwise be reached under any state's long arm or any federal question jurisdiction, so that the inconvenience of traveling across the country would reach only a few additional defendants, it is the correspondingly small number of parties who would be benefited that suggests action on the proposal be put off further.[105] So small a benefit is not worth validating so far-reaching a principle. It may be that this doubtful proposition is an idea whose time has passed.

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[103]Compare again the recognition of this distinction by the Supreme Court in Christopher v. Brusselback, 255 U.S. 356 (1921).

[104]This is not to suggest that the exercise of such power creates problems under *Erie* as suggested by Professor Abraham. *See* Note 13 *supra*. The concurrence of Mr. Justice Harlan in Hanna v. Plumer, 380 U.S. 460, 474 (1965) is persuasive on that score.

[105]A small number would undercut an argument of jurisdiction by necessity. Judge Friendly believes further study is needed on these proposals, especially in light of development of state court jurisdiction via long arms. H. FRIENDLY, FEDERAL JURISDICTION: A GENERAL VIEW 150 (1973). *See also* Currie, *The Federal Courts and the A.L.I.*, 36 U. CHI. L. REV. 1, 29-32 (1968). Indeed, California seems to have gone the whole route, extending jurisdiction where it seems fair, without reference to a nexus in the state with the cause of action. *See* Cornelison v. Chaney, 16 Cal. 3d 143, 545 P.2d 264 (1976), in which the California Supreme Court upheld constructive service of process over a Nebraska freight hauler who made about 20 trips a year to California and who was involved in an accident with a California driver in Nevada.

Notes

Copyright Reform and the Author's Right To "Vend": The Case of the Unpaid Manufacturer

I. Introduction

One who agrees to sell or manufacture goods for a customer has a panoply of remedies available to him in the event the customer refuses to pay the contract price.[1] One such remedy, the right to resell the goods, has been a part of commercial practice since the early common law.[2] However, when the goods in question are protected by copyright, the manufacturer's right of resale comes into conflict with the copyright holder's exclusive right to "vend" his work.[3] To resolve this conflict a court must either subordinate the state law remedy to the federally protected right,[4] or develop an

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[1]The Uniform Commercial Code provides:

> Where the buyer wrongfully rejects or revokes acceptance of goods or fails to make a payment due on or before delivery or repudiates with respect to a part or the whole, then with respect to any goods directly affected and, if the breach is of the whole contract (Section 2-612), then also with respect to the whole undelivered balance, the aggrieved seller may
>
> (a) withhold delivery of such goods;
>
> (b) stop delivery by any bailee as hereafter provided (Section 2-705);
>
> (c) proceed under the next section respecting goods still unidentified to the contract;
>
> (d) resell and recover damages as hereafter provided (Section 2-706);
>
> (e) recover damages for non-acceptance (Section 2-708) or in a proper case the price (Section 2-709);
>
> (f) cancel.

U.C.C. § 2-703.

Throughout this note the terms "seller" and "manufacturer" are used synonymously to designate one who has contracted to manufacture, produce, or assemble goods which in their final form represent an accurate reproduction of a copyrighted work. The person with whom the seller has contracted is the holder of the copyright, either by assignment, license, or because he is the creator of the original work. The terms "buyer," "author," "copyright proprietor," or "rights holder" will be used to refer to the holder of the copyright protecting the goods manufactured under the terms of such a contract.

[2]3 S. Williston, Sales § 546 (rev. ed. 1948).

[3]See notes 20-30 *infra.*

[4]Platt & Munk Co. v. Republic Graphics, Inc., 315 F.2d 847, 855 (2d Cir. 1963), suggested this solution. *But see* notes 100-10 and accompanying text *infra.*

interpretive compromise between the conflicting rights which will protect the expectations of both parties to such a contract.

The purpose of this Note is to analyze the approach to this problem taken by the courts, and to determine whether the precedential value of past decisions will be affected by the recent copyright revision, Public Law 94-553.[5]

II. The Right of Resale

The common law never doubted that a merchant holding title and possession of goods had the right to resell the goods when the buyer refused to make payment.[6] When title, but not possession, had already passed to the defaulting buyer, the merchant was said to have a lien on the goods to the extent of the unpaid purchase price, which could be enforced by reselling the goods to a more cooperative buyer.[7]

Under the Uniform Sales Act, the disappointed seller found his common law remedies codified, specifically the right of resale when title had already passed to the buyer.[8] While the Uniform Sales Act did impose certain conditions precedent on the right of resale, the Act did not hold the seller accountable for resale profits in excess of the original contract price.[9]

Today, every state but one has adopted the Uniform Commercial Code which provides an explicit right of resale free of the conditions imposed by the Uniform Sales Act, but like the prior Act, also free of accountability for excess profits on resale.[10] The Code rejects the "title" concept in establishing the rights of the parties, and the drafters specifically warn that there is no longer any need to distinguish between resale on the strength of the merchant's title and resale by virtue of a lien where title has passed.[11]

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[5]Copyright Act of 1976, Pub. L. No. 94-553, § 101, 90 Stat. 2541 (1976) (to be codified in 17 U.S.C. § 101). The 1976 Act provides in section 102 of the Transitional and Supplementary Provisions that the effective date for most provisions of the new Act is January 1, 1978. Consequently, an extended discussion of the 1909 Copyright Act and the cases arising during its reign is of more than historical interest. The only sections of the 1976 Act which took effect on January 1, 1977 are: § 118 treating licensing agreements between noncommercial broadcasters and copyright owners; § 304(b) granting a seventy-five year copyright term, from the date of creation, for copyrights in their renewal term, or registered for renewal between December 31, 1976, and December 31, 1977; and §§ 801-10 creating the Copyright Royalty Tribunal.

[6]*E.g.*, Johnson v. Powell, 9 Ind. 566 (1857).

[7]Perrine v. Barnard, 142 Ind. 448 (1895); Sherry v. Picken, 10 Ind. 375 (1858). When the buyer was guilty of misrepresentation or concealment, the seller was permitted to reclaim the goods after delivery. Brower v. Goodyer, 88 Ind. 572 (1883). *Cf.* U.C.C. § 2-702(2).

[8]Uniform Sales Act § 60.

[9]*Id.* § 60(1).

[10]U.C.C. § 2-706.

[11]*Id.*, Comment 3.

When the injured party is not a merchant selling goods, but rather an artisan who increases the value of a chattel by providing common law artisan's lien.[12] This lien is possessory in nature; while the artisan continues in possession, his lien is perfected against all other interests, but delivery of the chattel to the owner results in the loss of the lien.[13] At common law the artisan had no right to resell the chattel, but had to reduce his claim to judgment before levy of execution and sale were proper.[14] A number of states have codified the artisan's lien, some giving the lienholder the right to sell the chattel directly, and others giving him the right to foreclose his lien by judicial process.[15] Significantly, the Uniform Commercial Code preserves the effectiveness of the artisan's lien by excluding such liens from the scope of Article Nine and by giving the artisan's lien priority over earlier, perfected security interests in the chattel.[16]

The importance to the unpaid manufacturer of deciding whether his right of resale arises under the Code or under the artisan's lien law should not be underestimated. The Code establishes definite guidelines for public and private resales, while the various lien laws may require public sale only, or foreclosure by judicial proceedings before sale is permitted.[17] An improper resale may leave the

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[12]Walls v. Long, 2 Ind. App. 202, 28 N.E. 101 (1891).

[13]Tucker v. Taylor, 53 Ind. 93 (1876).

[14]RESTATEMENT OF SECURITY § 72, Comments a, b, d (1941).

[15]*Id.* The most common form of statute requires notice to the owner of the chattel, followed by public sale, with a period of redemption before sale. Some statutes provide for a deficiency judgment in the event the sale price is insufficient to compensate the artisan. *Compare* N.Y. LIEN LAW §§ 180, 200 (McKinney Supp. 1968), *with* IND. CODE §§ 32-8-30-1 to -2 (Burns 1973).

[16]U.C.C. §§ 9-104(c), 9-310.

[17]See note 15 *supra*. *See also* U.C.C. § 9-501(1), giving a secured party the option of proceeding against the collateral by judicial foreclosure.

The resale provisions of Article Two, governing an injured seller, read in full:

> (1) Under the conditions stated in Section 2-703 on seller's remedies, the seller may resell the goods concerned or the undelivered balance thereof. Where the resale is made in good faith and in a commercially reasonable manner the seller may recover the difference between the resale price and the contract price together with any incidental damages allowed under the provisions of this Article (Section 2-710), but less expenses saved in consequence of the buyer's breach.
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> (2) Except as otherwise provided in subsection (3) or unless otherwise agreed resale may be at public or private sale including sale by way of one or more contracts to sell or of identification to an existing contract of the seller. Sale may be as a unit or in parcels and at any time and place and on any terms but every aspect of the sale including the method, manner, time, place and terms must be commercially reasonable. The resale must be reasonably identified as referring to the broken contract, but it is not necessary that the goods be in existence or that any or all of them have been identified to the contract before the breach.
>
> (3) Where the resale is at private sale the seller must give the buyer reasonable notification of his intention to resell.

labor and/or materials, the remedy for a customer's default is the manufacturer with no other remedy but an action for the contract price—an unhappy result if the buyer is defaulting because of insolvency.[18]

In any case, when the defaulting buyer is also the holder of a copyright protecting the manufactured articles, the unpaid manufacturer must not only have the right to resell under state law, he must, additionally, circumvent the copyright holder's exclusive right to "vend" the copyrighted work.[19] The manufacturer's success depends on his appreciation of the nature and scope of his adversary's federally created rights.

III. The Right To Vend

The United States copyright laws derive from the constitutional authorization to "promote the Progress of Science and useful Arts, by

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(4) Where the resale is at public sale

(a) only identified goods can be sold except where there is a recognized market for a public sale of futures in goods of the kind; and

(b) it must be made at a usual place or market for public sale if one is reasonably available and except in the case of goods which are perishable or threaten to decline in value speedily the seller must give the buyer reasonable notice of the time and place of the resale; and

(c) if the goods are not to be within the view of those attending the sale the notification of sale must state the place where the goods are located and provide for their reasonable inspection by prospective bidders; and

(d) the seller may buy.

(5) A purchaser who buys in good faith at a resale takes the goods free of any rights of the original buyer even though the seller fails to comply with one or more of the requirements of this section.

(6) The seller is not accountable to the buyer for any profit made on any resale. A person in the position of a seller (Section 2-707) or a buyer who has rightfully rejected or justifiably revoked acceptance must account for any excess over the amount of his security interest, as hereinafter defined (subsection (3) of Section 2-711).

U.C.C. § 2-706.

[18]Braswell v. American Nat'l Bank, 117 Ga. App. 699, 161 S.E.2d 420 (1968), held that a sale conducted without notice to the debtor would deny the secured party, selling under § 9-504 of the Code, any right to a deficiency judgment. *Accord,* Jefferson Credit Corp. v. Marcano, 60 Misc. 2d 138, 302 N.Y.S.2d 390 (N.Y. Civ. Ct. 1969). *Contra,* Mutual Finance Co. v. Politzer, 21 Ohio St. 2d 177, 256 N.E.2d 606 (1970).

While the *Politzer, Marcano,* and *Braswell* decisions were concerned with the sale of collateral by a secured party under Article Nine of the Code, it is predictable that cases discussing the requirement of a "commercially reasonable" sale found in § 9-504 will be influential in defining a "commercially reasonable" resale under § 2-706. *See generally* J. White & R. Summers, Handbook of the Law Under the Uniform Commercial Code § 7-6 (1972) [hereinafter cited as White & Summers].

[19]See notes 38-41 *infra* and accompanying text.

securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries."[20] The 1909 Copyright Act gives an author the right to "print, reprint, publish, copy, and vend" his protected works.[21] Of these enumerated rights, it has been correctly stated that the right to vend and the right to publish differ from all of the other rights granted to an author, in that vending and publishing deal directly with the public distribution of a work, while the other rights concern distribution only indirectly because they are all concerned with reproducing the work.[22] Thus, in the first instance, distribution is controlled by deciding how many copies of a given work will be reproduced for future sale to the public. The right to vend and the right to publish allow an author to further control the distribution of his work by deciding when, for what price, to whom, and how many of the authorized copies will then be transferred. In this light, the right to vend may be seen as complementing the rights of reproduction, making it possible for an author to control, or even to prevent, the distribution of his copyrighted work.[23]

Standing alone, the author's right to vend has been carefully defined by judicial opinion.[24] The vending monopoly allows an author to control the disposition of particular copies[25] of his work until he has parted with title to those copies.[26] Thereafter, in the absence of a valid contractual restriction, the transferee may dispose of those copies as he pleases.[27] It must be emphasized, however, that while the subsequent disposal of the copies by the transferee does not infringe the author's vending right, the transferee does not have the privilege of making additional copies, or of doing any of the other acts granted exclusively to the author with respect to the work itself.[28]

This critical limitation on the transferee's interest in the copyright, as well as the unlimited right of disposal as to the particular copies transferred, stems from the unique distinction between a copyright and the objects protected thereby. The transfer of a copyrighted object is a transfer of the object only, and not a transfer

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[20]U.S. CONST. art. I, § 8, cl. 8.

[21]17 U.S.C. § 1 (1970) (amended 1976).

[22]M. NIMMER, NIMMER ON COPYRIGHT § 103.31 (1963) [hereinafter cited as NIMMER].

[23]*Id.*

[24]*E.g.*, Blazon, Inc. v. DeLuxe Game Corp., 268 F. Supp. 416, 433-34 (S.D.N.Y. 1965).

[25]For the rationale of applying the vending monopoly only to copies of the work, see Corcoran v. Montgomery Ward & Co., 121 F.2d 572 (9th Cir. 1941).

[26]Henry Bill Publ. Co. v. Smythe, 27 F. 914 (C.C.S.D. Ohio 1886).

[27]Bobbs-Merrill Co. v. Straus, 210 U.S. 339 (1908); Independent News Co. v. Williams, 293 F.2d 510 (3d Cir. 1961).

[28]Hampton v. Paramount Pictures Corp., 279 F.2d 100 (9th Cir. 1960); National Geographic Soc'y v. Classified Geographic, Inc., 27 F. Supp. 655 (D. Mass. 1939).

of any of the author's rights.[29] The reason that resale of a protected copy by the transferee is no infringement of the right to vend is because that particular monopoly ceases to exist after the initial transfer, and not because the transferee has obtained from the author an exclusive right to vend that copy.[30]

The distinction between the copyrighted object and the copyright itself was codified in section 27 of the 1909 Copyright Act.[31] After stating that the transfer of the object is not a transfer of the copyright, and conversely, the assignment of the copyright is not a transfer of the material object, section 27 continues: "[B]ut nothing in this title shall be deemed to forbid, prevent, or restrict the transfer of any copy of a copyrighted work, the possession of which has been lawfully obtained."[32]

While the first clause of section 27 seems never to have disturbed the courts, the "but nothing" clause has met with less than consistent interpretation.[33] The difficulty stems from the language of the "but nothing" clause which speaks in terms of lawful possession. The Committee Report which accompanies section 27, on the other hand, implies that lawful possession will result only from a "first sale" by the author.[34]

This unfortunate divergence in terminology provides authority for the conflicting positions of both the unpaid manufacturer and the defaulting buyer in a disputed resale of copyrighted goods. Predictably, the unpaid manufacturer will argue that his possession is "lawful," in literal compliance with section 27, so that a resale in the event of breach is no infringement of the right to vend. The copyright holder will argue that the Committee Report indicates the impropriety of a literal reading of the "but nothing" clause. Since the defaulting buyer has not yet had the privilege of voluntarily making the "first sale" of the particular articles, he will insist that his right to vend those articles has not been lost.

Faced with these conflicting interpretations, the United States Court of Appeals for the Second Circuit rejected both arguments, holding in *Platt & Munk Co. v. Republic Graphics, Inc.*[35] that the "first sale" referred to in the Committee Report need not be "voluntary," but could be involuntary, based on implied consent or estoppel.[36]

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[29]Stephens v. Cady, 55 U.S. (14 How.) 528 (1852).

[30]United States v. Wells, 176 F. Supp. 630 (S.D. Tex. 1959).

[31]17 U.S.C. § 27 (1970) (amended 1976).

[32]*Id.*

[33]*Compare* United States v. Wells, 176 F. Supp. 630 (S.D. Tex. 1959), *with* Creative Arts, Inc. v. Abady & Sultan, Inc., 134 U.S.P.Q. 388 (S.D. Fla. 1962).

[34]H.R. REP. NO. 2222, 60th Cong., 2d Sess. 19 (1909).

[35]315 F.2d 847 (2d Cir. 1963).

[36]*Id.* at 854.

The plaintiff, Platt & Munk, had entered into a series of contracts with defendant, Republic Graphics, obligating Republic to manufacture and deliver to Platt & Munk a shipment of educational toys and games which were protected by a copyright in plaintiff's name. When plaintiff refused to accept the shipments, claiming the goods were defective, Republic notified plaintiff of its intention to resell the goods. Plaintiff then sought and received a preliminary injunction restraining the sales.[37]

On appeal, Republic contended that under section 141 of the New York Personal Property Law,[38] it had the right of resale given an unpaid seller of goods. Further, since Republic's possession of the goods was "lawfully obtained," the vending monopoly could not "forbid, prevent or restrict the transfer" of the copyrighted articles.[39] In rejecting this contention, the court noted that the argument proved too much. Throughout the manufacturing and distribution process, copyrighted goods pass through the hands of shippers and other bailees whose possession is "lawful," but who have no authority to sell the goods.[40] While an unauthorized sale by a bailee in possession would be grounds for an action in conversion, the copyright holder's vending rights would be lost to him, leaving an unanticipated hiatus in the rights and remedies created by the federal statute.[41]

Relying on the Committee Report's reference to "first sale" and the further statement therein that section 27 was "not intended to change in any way existing law," the *Platt & Munk* court held that lawful possession was not enough to permit the vending of copyrighted goods against the copyright holder's wishes.[42] However, the court also rejected plaintiff's contention that the "first sale" language meant, literally, a first sale voluntarily made for adequate consideration.[43] Such a view would immunize copyrighted goods from creditor process and commercial obligations, a view once adhered to in decisions of the last century but long since rejected.[44] Instead, the correct view in the court's opinion was that the first sale required to terminate the vending monopoly could be either voluntary or

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[37]*Id.* at 850.

[38]This statute was identical to § 60 of the Sales Act, repealed by the adoption of the Uniform Commercial Code. *See* N.Y. U.C.C. § 2-706 (McKinney 1964).

[39]315 F.2d at 851.

[40]*Id.* The court's apprehension on this score was not entirely groundless. *See* Kipling v. G.P. Putnam's Sons, 120 F. 631 (2d Cir. 1903).

[41]17 U.S.C. § 101 (1970) (amended 1976). *See generally* NIMMER, *supra* note 22, § 103.31.

[42]315 F.2d at 851.

[43]*Id.* at 853-54.

[44]*Compare* Dart v. Woodhouse, 40 Mich. 399, 29 Am. R. 544 (1879), *with* Wilder v. Kent, 15 F. 217 (C.C.W.D. Pa. 1883). See Note, *Creditors' Rights Against Interests in Patents and Copyrights*, 26 VA. L. REV. 1038 (1940).

involuntary, as in the case of seizure by creditors, based on a theory of implied consent or estoppel.[45] When the holder of a copyright has unjustifiably refused to pay the contract price for copies of his work, the court continued, the "first sale" requirement is satisfied, and the unpaid manufacturer has the right to resell the goods. However, when the copyright holder asserts that he is justified in withholding payment, the manufacturer must be restrained from reselling the goods until he proves to the court that he is not the perpetrator, but the victim of the breach.[46]

While the *Platt & Munk* court's adoption of the "first sale" language has been criticized,[47] that criticism weakens when two aspects of the decision are placed in perspective: first, the court's actual treatment or interpretation of the "first sale" doctrine; and second, the court's requirement that a copyright holder be permitted to enjoin resale on the strength of a good faith claim that his refusal to pay was justified.[48]

The court's treatment of the "first sale" doctrine must, in turn, be analyzed on two levels to appreciate its superiority over the "lawful possession" approach: (a) the justification or rationale for requiring a first sale at all; and (b) the definition of first sale as applied by the court.

A. Rationale of First Sale Doctrine

The earliest cases discussing "first sale" under a prior Copyright Act,[49] indicate the obvious conclusion that the doctrine is a double-edged sword demarcating the boundary between the author's right to control the distribution of copies of his work, on one side, and the policies against restraints on trade and those favoring the free alienation of property, on the other side.[50]

In *Henry Bill Publishing Co. v. Smythe*,[51] a copyrightee sold books by private subscription only. When the author's agent placed several books with a book dealer—an act beyond the agent's scope of authority—the author was able to enjoin the dealer from selling the

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[45]315 F.2d at 854. The *Platt & Munk* court cited Henry Bill Publ. Co. v. Smythe, 27 F. 914 (C.C.S.D. Ohio 1886), in support of the estoppel theory, but *Smythe* merely treated the estoppel question by way of dictum. 27 F. at 918. For an excellent advancement of the theory that an unpaid manufacturer has an implied license to resell copyrighted articles, see Note, *The Manufacturer's Right To Resell Patented and Copyrighted Goods*, 38 N.Y.U. L. REV. 948 (1963).

[46]315 F.2d at 855.

[47]NIMMER, *supra* note 22, § 103.323.

[48]315 F.2d at 855.

[49]Act of Feb. 3, 1831, ch. 16, § 1, 4 Stat. 436.

[50]*Cf.* NIMMER, *supra* note 22, § 103.31.

[51]27 F. 914 (C.C.S.D. Ohio 1886).

books, based on an infringement of the copyright. The defendant's contention that the plaintiff had lost the vending monopoly as to the copies in question when the books had been first sold was dismissed by the court: "[T]he absence of [plaintiff's] authority to sell his literary property constitutes the defect of [defendant's] title, no matter how that want of authority arises."[52] By way of dictum, the *Smythe* court indicated that plaintiff might have been estopped from denying a "first sale" had he placed the books with brokers or distributors for general sale.[53]

On the other hand, the copyright holder in *Harrison v. Maynard, Merrill & Co.*[54] was held to have lost his vending monopoly when he allowed a book binder to sell, for scrap only, fire damaged copies which the purchaser promptly rebound and sold as second hand books. Once the author had parted with title, held the court, he could not restrain the purchaser's use of that particular copy by asserting copyright infringement.[55]

Likewise, in *Bobbs-Merrill Co. v. Straus*,[56] the United States Supreme Court held that a publisher who sold books to the defendant, a department store, could not assert copyright infringement when the defendant sold the books at less than the agreed-upon resale price which plaintiff had printed in the front of the books. Once the "first sale" was made, the Court held, plaintiff was limited to an action in contract and had no further vending monopoly as to the particular copies he had sold.[57]

The following year, partially in response to *Bobbs-Merrill*, Congress codified the first sale doctrine in the "but nothing" clause to

> make it clear that there is no intention to enlarge in any way the construction to be given to the word 'vend' . . . . Your Committee feels that it would be most unwise to permit the copyright proprietor to exercise any control whatever over the article which is the subject of copyright after said proprietor has made the first sale.[58]

Against this authority,the court in *Platt & Munk Co. v. Republic Graphics, Inc.*[59] measured the likely aftermath of adopting the language of lawful possession found in the "but nothing" clause. Deciding that a literal reading would permit bailees to escape

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[52]*Id.* at 918.
[53]*Id.* *See* discussion of *Smythe* in note 45 *supra.*
[54]61 F. 689 (2d Cir. 1894).
[55]*Id.* at 691.
[56]210 U.S. 339 (1908).
[57]*Id.* at 350.
[58]H.R. REP. No. 2222, 60th Cong., 2d Sess. 19 (1909).
[59]315 F.2d 847 (2d Cir. 1963).

infringement actions for unauthorized sales of an author's work, the court concluded that language of "possession" had been used to demonstrate that the "but nothing" clause was intended as a limitation on the first half of section 27.[60]

This reasoning seems correct when it is noted that the first half of section 27 speaks of "the sale or *conveyance*, by gift or otherwise, of the material object . . . ."[61] Thus, to apply the "but nothing" clause to the various types of conveyances other than sales, Congress employed general language of possession, rather than of purchase. It cannot be gainsaid that a bailment is not a conveyance.[62] The former is a mere entrusting, while the latter is a transfer of title.[63]

However, Republic, the defendant in *Platt & Munk*, asserted that it had title to the goods because it had supplied the raw materials used in the manufacturing process, and since Platt & Munk had not taken delivery, the vending right never attached.[64] Rejecting this contention, the court disparaged the idea that "copyright protection should turn on which party has furnished the physical stuff to which the copyrighted conception is affixed . . . ."[65]

The language used by the court in rejecting Republic's "title theory" contains two key ideas which the court failed to pursue. The first, that Republic furnished the "physical stuff," correctly differentiates between the tangible and intangible components of copyrighted articles.[66] Republic had title to the physical stuff, but it did not have title to Platt & Munk's copyright component. Therefore, so

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[60]*Id.* at 851.

[61]17 U.S.C. § 27 (1970) (amended 1976) (emphasis added).

[62]*Compare* Lyon v. Lenon, 106 Ind. 567, 7 N.E. 311 (1886), *with* Hagey v. Schroeder, 30 Ind. App. 151, 65 N.E. 598 (1902).

[63]R. BROWN, THE LAW OF PERSONAL PROPERTY § 10.5 (3d ed. 1975).

[64]Brief for Appellant at 3-6, Platt & Munk Co. v. Republic Graphics, Inc., 315 F.2d 847 (2d Cir. 1963).

[65]315 F.2d at 854.

[66]This attack on the manufacturer's title theory is mounted in Note, *The Manufacturer's Right To Resell Patented and Copyrighted Goods*, 38 N.Y.U. L. REV. 948 (1963). The commentator there argues that a manufacturer has title to the physical goods, not the author's copyright component. Hence, the manufacturer cannot resell the goods because his title is defective as to the combined tangible and intangible elements. *Id.* at 960. This argument clearly ignores the statutory distinction between copyright and the tangible objects protected thereby. 17 U.S.C. § 27 (1970) (amended 1976). The *Platt & Munk* court, too, stumbled on its rejection of the title theory. The court gave no explanation of why the theory was unacceptable, but merely dismissed it as "exceedingly odd." 315 F.2d at 854.

A conceptually smoother approach would concede a manufacturer's title to the goods, while holding that an attempted resale will, nonetheless, infringe the vending monoploy, unless title was obtained by a transfer from the author. See notes 131-33 *infra* and accompanying text.

The language of section 27, the Committee Report, and the discussion in *Platt & Munk* are each sufficiently broad to permit this restriction on the manufacturer's title.

long as the two components were united in the goods, Republic had only two alternatives: disassemble the goods and sell the material as scrap,[67] or claim that Platt & Munk's conduct somehow resulted in a conveyance to Republic of the entire product, thereby giving Republic title to not just the goods, but to the *copyrighted* goods.[68]

The second idea touched upon by the court lurks in the statement that the "copyrighted conception is affixed" to the physical stuff. This view strongly implies, and other cases have held,[69] that the manufacturer of copyrighted goods is not a seller, but rather an artisan who increases the value of a chattel by the addition of labor or material, or both.[70]

In *North American Leisure Corp. v. A & B Duplicators, Ltd.*,[71] the manufacturer, A & B, had reproduced from NAL's master tape a huge inventory of sound recordings. The tape, cartridges, and packages had been supplied by the manufacturer. A & B kept the inventory in its control and received assurances from NAL that the manufacturer had a lien on the inventory for the unpaid purchase price. During NAL's bankruptcy proceedings the referee found, and was affirmed by the district court, that A & B had a vendor's lien because it had provided the raw materials making up the goods. On appeal, nine years after skirting the issue in *Platt & Munk*, the Court of Appeals for the Second Circuit decided that A & B had an artisan's lien, not a vendor's lien.[72]

Such an approach has the further advantage of accurately reflecting the underlying policies of the vending monopoly itself. See text accompanying notes 22, 23 and 49-60 *supra*. Where the terms of the contract indicate an intention to make the manufacturer the owner of the copies, or where the author's refusal to pay the contract price is unjustified, there is no objection to finding that the contract or conduct, respectively, constitutes a transfer of title from the author, thereby ending the right to vend.

Finally, this view of title does no violence to existing case law because the contract terms or conduct of the parties is the touchstone of the manufacturer's right to resell copyrighted goods, under either view of the title question. *Compare* Platt & Munk Co. v. Republic Graphics, Inc., 315 F.2d 847 (2d Cir. 1963), *with* United States v. Wells, 176 F. Supp. 630, 633 (S.D. Tex. 1959).

[67]This was the apparent result suggested by Sawin v. Guild, 21 F. Cas. 554 (C.C.D. Mass. 1813) (No. 12, 391). There, Justice Story held that a sheriff who sold patented machines pursuant to an execution against the patentee had sold only the material, not any part of the patent. Since the right of "use" granted by the patent laws, now codified at 35 U.S.C. § 154 (1970), was not a part of the sale, Justice Story's decision avoided an infringement action against the sheriff, but left the purchaser at execution sale with little more than scrap metal.

[68]See note 66 *supra*, and the text accompanying notes 132-34 *infra*.

[69]See discussion in note 72 *infra*.

[70]See text accompanying notes 12-14 *supra*.

[71]468 F.2d 695 (2d Cir. 1972).

[72]Why the issue was not squarely faced in *Platt & Munk* is somewhat mysterious. The authority relied upon in deciding *A & B Duplicators* was already available when

Obviously, had the Second Circuit decided in *Platt & Munk* that Republic was an artisan, as the lower court had done,[73] the higher court could have ended Republic's title theory with little effort. In that event, title to the goods would have been lodged in *Platt & Munk*, subject only to a lien for the unpaid debt. Instead, the court directed that Republic, on remand, have a speedy trial on the issue of whether Platt & Munk's refusal to pay was justified, or whether Platt & Munk had been in default in the payment of the price for an unreasonable time.[74] The former question applied to artisan's liens, the latter to seller's remedies under the Sales Act.

Still, the rationale underlying the first sale doctrine was left intact because, regardless of Republic's status, the central question in the view of the Second Circuit was whether a manufacturer should be permitted to resell copyrighted goods merely on the strength of his lawful possession, or whether the balancing of an author's rights against the policy favoring the free alienation of property, in this instance, required something more (*i.e.*, a first sale) on the author's part.[75] Opting for a first sale requirement, it remained for the court to determine just what actions by the author would constitute such a conveyance.

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the *Platt & Munk* decision was written. William H. Wise & Co. v. Rand McNally & Co., 195 F. Supp. 621 (S.D.N.Y. 1961), had held that a book printer provides a service, not a sale of goods, when he affixes the publisher's literary property to the physical copies.

Somewhat earlier, the same conclusion had been reached in Gross Income Tax Division v. W. B. Conkey Co., 228 Ind. 352, 90 N.E.2d 805 (1950), *cert. denied*, 340 U.S. 941 (1951). There, the Indiana Supreme Court held that since a printer provided services, not a sale of goods, the state could tax the printer's business transactions without restricting the "sale of goods" in interstate commerce.

Although *A & B Duplicators*, *Wise*, and *Conkey* focused on taxation or creditors' rights rather than copyright infringement, it seems anomalous to say that a manufacturer of copyrighted goods has an artisan's lien when his adversary is another creditor of the copyright holder, but a vendor's lien when the adversary is the copyright holder himself.

Part of the court's reluctance to find that Republic was an artisan may have stemmed from the fact that Republic had attempted to resell the goods privately rather than publicly as required by the New York Lien Law. Furthermore, where the contract does not require payment until delivery, a possessory lien does not (indeed, could not) arise. Newark Slip Cont. Co. v. New York Credit Men's Adjustment Bureau, Inc., 186 F.2d 152 (2d Cir. 1951). The court may have hesitated to restrict manufacturers of copyrighted goods to an artisan's lien when the bulk of such manufacturing contracts no doubt call for delivery before payment. In Republic's case, however, possession had been regained following Platt & Munk's rejection of the goods, so that the artisan's lien would still be effective security for the unpaid debt. Platt & Munk Co. v. Republic Graphics, Inc., 315 F.2d 847, 849-50 (2d Cir. 1963).

[73]315 F.2d at 855 n.4.

[74]*Id.* at 855.

[75]*Id.* at 852.

B. Definition of First Sale Doctrine

In addition to what was quoted above, the Committee Report which accompanied section 27 of the 1909 Act clearly indicated that the statutory language was "not intended to change in any way existing law, but simply to recognize the distinction, long established, between the material object and the right to produce copies thereof."[76]

As early as 1852, the Supreme Court held in *Stephens v. Cady*[77] that copperplates of a copyrighted map purchased at execution sale could not be used to print copies of the map. The defendant had purchased only the material object at the sale, said the Court, not the intangible copyright; hence he had no right to produce copies, since "copying" is part of the copyright which still remained in the plaintiff, the copyright holder.[78] By way of dictum, the Court did suggest that a creditor's bill in equity, with personal jurisdiction over the copyright holder, and a court-compelled transfer of the intangible copyright might overcome the hurdle of the tangible-intangible distinction.[79]

Stephens v. Cady and a number of other state and federal opinions[80] left the impression that an author's intangible copyright could not be subjected to creditor process for the payment of the author's debts. However, in *Ager v. Murray*,[81] a patent case,[82] the Supreme Court indicated that federally protected rights were indeed subject to creditor process by holding that an equity court, having

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[76]H.R. REP. No. 2222, 60th Cong., 2d Sess. 19 (1909).

[77]55 U.S. (14 How.) 528 (1852).

[78]*Id.* at 530-31.

[79]*Id.* at 531-32.

[80]*See, e.g.*, Stevens v. Gladding, 58 U.S. (17 How.) 447 (1854); Dart v. Woodhouse, 40 Mich. 399, 29 Am. Rep. 544 (1879). *See generally* Note, *Creditors' Rights Against Interests in Patents and Copyrights*, 26 VA. L. REV. 1038 (1940).

[81]105 U.S. 127 (1881).

[82]it is not uncommon to find courts relying on patent cases in rendering copyright opinions. The many similarities between the rights of an author and those of an inventor make this practice acceptable. *Compare* 17 U.S.C. § 1 (1970), *as amended by* Copyright Act of 1976, Pub. L. No. 94-553, § 101, 90 Stat. 2541 (copyright), *with* 35 U.S.C. § 154 (1970) (patent). While patent law is beyond the scope of this note, one difference from copyright must be noted. In addition to the right to vend, an inventor enjoys the exclusive right to "use" his invention. This right, like the others, may be assigned or licensed separately. Adams v. Burke, 84 U.S. (17 Wall.) 453 (1873).

When an unpaid manufacturer of patented goods attempts to resell, he must not only overcome the patentee's vending monopoly, he must additionally seek a court-compelled transfer of the right of "use." Without this added effort, the purchaser at resale may find that any attempt to use the article will be met with an infringement action, reducing the practical value of the article to scrap value only. See note 67 *supra*.

jurisdiction over the rights holder, could compel a transfer of the intangible patent rights, giving the purchaser the full value of his purchase.[83]

Following this lead, a lower federal court carried the purchaser's rights one step further. In *Wilder v. Kent*,[84] the defendant had purchased two patented machines at a sheriff's sale, held pursuant to a writ of execution against the plaintiff, whose assignment from the patentee gave him the exclusive right of use in his territory. In holding that the defendant had not infringed the plaintiff's rights, the court reasoned that the purchaser at a sheriff's sale ought to succeed to the interests of the debtor.[85] Because the purchaser claimed no rights in the patent, only in the machines, there should be no difference between a voluntary sale by the plaintiff, and an involuntary sale by the sheriff, and the purchaser would have whatever interest in the machines the debtor had had before the sale.[86]

If execution and sheriff's sale are the equivalent of a voluntary sale by the rights holder, the conclusion is inescapable that other state processes, such as lien foreclosures or the resale rights of an unpaid manufacturer may just as well fulfill the requirement of a "first sale" by an author in copyright cases. It was so held by the *Platt & Munk* court which referred to *Wilder v. Kent* as the "sensible rule."[87]

The question to be asked, said the *Platt & Munk* court, was whether the copyright holder had "received from his creditor some value for which the copyrighted . . . article is now demanded unless the debt is paid."[88] The answer must be in the affirmative when a manufacturer has fulfilled his contract obligations by producing the goods and then seeks payment from a defaulting copyright holder. The buyer, having received the benefit of the contract, should not be placed in a position to demand more favorable terms from the manufacturer by withholding payment, knowing that the manufacturer cannot look to the goods for security because they are protected by copyright. By equating the buyer's breach with a "first sale" on his part, the court effectively shifted any unwarranted

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[83]105 U.S. at 130-31.

[84]15 F. 217 (C.C.W.D. Pa. 1883).

[85]*Id.* at 219. This conclusion, no doubt, was based on the theory that a sale by the patentee will usually eliminate the right of use if so stated in the contract. Bloomer v. McQuewan, 55 U.S. (14 How.) 539 (1852).

[86]This reasoning is sound as applied to copyrights, but the court erred in its treatment of the right of "use," since no court-compelled transfer of this intangible right had been obtained. See discussion in note 82 *supra*.

[87]315 F.2d at 854.

[88]*Id.*

bargaining leverage away from a potentially dishonest buyer.[89] This is particularly important when the buyer's financial status is shaky, making a resale of the goods the only remedy realistically available to the manufacturer.[90]

The essence of a first sale, then, as defined by the *Platt & Munk* court is that the author has received a benefit from the manufacturer, just as the author would have received a benefit from the outright sale of copies of his work.[91] In either case, having received the quid pro quo, the author must make delivery. When the creditor already has the copies, the author's failure to meet his obligations constitutes the "conveyance" making the creditor's possession "lawful."[92] When the copies are not in the creditor's possession, the state law process of levy and execution makes the sheriff's possession lawful, so that the purchaser at execution sale receives the copies free from the vending rights of the author.[93] However, since the first sale doctrine ends only the vending monopoly, the purchaser from the sheriff (or from the reselling manufacturer) may not copy, exhibit, make new versions, or exercise any of the other exclusive rights which remain in the author.[94] These other intangible rights remain subject to the *Ager v. Murray* requirements of personal jurisdiction and court-compelled transfer before the purchaser attempting to exercise these rights will be safe from infringement suits.[95]

Viewed in this fashion, the *Platt & Munk* requirement of a "first sale" is superior to the literal "lawful possession" approach because the latter interpretation would create a gap in the copyright remedies against dishonest bailees.[96] At the same time, the court's forward looking definition of "first sale" as a voluntary or involuntary

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[89]See text accompanying notes 104-11 *infra.*

[90]*Id.*

[91]"In such event . . . the copyright owner has received 'his reward' . . . ." 315 F.2d at 855.

[92]*Id.*

[93]*See, e.g.,* Independent Film Distrib., Ltd. v. Chesapeake Indus., Inc., 148 F. Supp. 611 (S.D.N.Y. 1957), *rev'd on other grounds,* 250 F.2d 951 (2d Cir. 1958).

[94]See text accompanying note 28 *supra.*

[95]In Independent Film Distrib., Ltd. v. Chesapeake Indus., Inc., 148 F. Supp. 611 (S.D.N.Y. 1957), the defendant, a film processor, had foreclosed a statutory lien given an unpaid processor on the film, the exhibition and the distribution rights. N.Y. LIEN LAW § 188 (McKinney Supp. 1968). When defendant attempted to sell the film and the rights following a default judgment against the rights holder, the rights holder sued alleging infringement. The court held that jurisdiction, obtained by substituted service, had been insufficient to pass the intangible copyright. *Cf.* Ager v. Murray, 105 U.S. 127 (1881).

[96]NIMMER, *supra* note 22, § 103.31 at 385.1 n.73. Interestingly, Nimmer appears to change course when he later criticizes *Platt & Munk* for its adoption of the "first sale" doctrine. There, he argues that an action in conversion or breach of contract would be an adequate remedy when faced by a dishonest bailee. *Id.* § 103.323, at 386.

payment for benefits received, protects unpaid manufacturers against overreaching copyright proprietors.[97]

By making the buyer's breach of contract the equivalent of a "first sale," the *Platt & Munk* court permanently resolved the legal question, but created a question of fact requiring resolution with each new case in which the fact is controverted by the parties.[98] Thus, the court was forced to develop a method of resolving the issue of breach which would not tip the scales it had delicately balanced in resolving the legal issues. The court's solution was to limit the manufacturer's state law remedy of self-help by permitting a buyer to challenge and enjoin the threatened resale of copyrighted goods, and to grant the parties a speedy resolution of the factual issue of breach.[99] This formula is the second aspect of the court's decision which enables it to overcome the criticism leveled at the first sale requirement.

The *Platt & Munk* court, while deciding that in a proper case the right of resale "must yield to the federally created right,"[100] qualified that statement by saying that this subordination would only occur "where the copyright owner makes a good faith claim that its failure to pay for the goods was justified . . . ."[101] When the author admits his default by doing nothing, or when he seeks an injunction but cannot marshal sufficient evidence for even a "good faith claim," the unpaid manufacturer may exercise the right of resale.[102] However, the right of resale is not an absolute right to be exercised unilaterally by a manufacturer in every situation. In a proper case the buyer with a valid objection can move to protect his contract rights, as well as his copyright.[103]

Under the Uniform Sales Act, a buyer had the right to seek specific performance of the contract. The Sales Act intended to liberalize this buyer's remedy by not requiring that the buyer demonstrate the inadequacy of his legal remedy or the uniqueness of the goods.[104] Instead, the granting of relief was left to the informed discretion of the court.[105] The Uniform Commercial Code has carried

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[97]See notes 104-11 *infra* and accompanying text.

[98]The court rationalized: "The difficulty comes from the fact that the law gives an unpaid manufacturer a right to sell *without prior adjudication of the merits of his claim.*" Platt & Munk Co. v. Republic Graphics, Inc., 315 F.2d 847, 855 (2d Cir. 1963) (emphasis added).

[99]*Id.* at 855.

[100]*Id.*

[101]*Id.*

[102]Admittedly, this conclusion is drawn by negative implication, but this conclusion hardly seems debatable in view of the court's own language: "*Where* the copyright owner makes a good faith claim." *Id.* (emphasis added).

[103]U.C.C. § 2-716(1).

[104]UNIFORM SALES ACT § 68.

[105]*Id. But see* Eastern Rolling Mill Co. v. Michlovitz, 157 Md. 51, 145 A. 378 (1929); Manchester Dairy System, Inc. v. Hayward, 82 N.H. 193, 132 A. 12 (1926).

forward the liberal approach of the Sales Act by permitting specific peformance "where the goods are unique or in other proper circumstances."[106] Presumably, a buyer who invokes this particular remedy combined with a count to enjoin a resale by the manufacturer must still post bond and demonstrate the likelihood that he will ultimately prevail in the dispute.[107]

The *Platt & Munk* court, however, would appear to sanction the granting of an injunction on a lesser showing than that traditionally required of the moving party. The test there announced was that the buyer need only make "a good faith claim that . . . failure to pay for the goods was justified."[108]

Conceivably, when faced with the issue, a federal district court might well equate the two standards. That is, a buyer who cannot demonstrate the likelihood that he will prevail is not making a good faith claim. Such an approach not only borders on circuity, it runs the risk of reversal in light of the Second Circuit's statement that, to this extent, "state contract or lien law must yield to the federally created right."[109] Assuming that the higher court was not unmindful of a maligned buyer's right to enjoin resale in a proper case, it becomes evident that the yielding, or subordination of state law to federal law was an alteration in degree rather than substance.

Furthermore, whether the buyer of goods is an author with a federally protected right, or a non-copyright buyer with a state law right to have his goods delivered, a breaching seller cannot seriously expect to deprive his buyer of something substantial without being forced into litigation. Conversely, when the buyer is the breaching party, he will seldom attempt to block the seller's efforts to salvage what he can by reselling the goods, because the proceeds of resale will mitigate the buyer's damage liability.[110] It is only where the basis of a dispute is genuine and the goods in question are unique (*e.g.*, copyrighted goods) that the buyer will want to enjoin the resale.

Permitting the buyer in copyright disputes to enjoin an

Apparently, the courts were reluctant to take advantage of the Sales Act's liberal approach to specific performance in sales of goods cases. *See generally* WHITE & SUMMERS *supra* note 18, § 6-6.

[106]U.C.C. § 2-716(1).

[107]Prior to 1970, the posting of bond was required by statute in Indiana. Act of April 7, ch. 38 § 183, 1881 Indiana Acts 240 (repealed by Act of March 13, ch. 191 § 3, 1969 Indiana Acts 723). Currently, the applicable statute provides: "Upon the granting or continuing of an injunction, such terms and conditions may be imposed upon the party obtaining it, as may be deemed equitable." IND. CODE § 34-1-10-5 (Burns 1973).

[108]315 F.2d at 855.

[109]*Id.*

[110]U.C.C. § 2-706(1). *Cf.* National Importing Co. v. California Prune & Apricot Growers, Inc., 85 Ind. App. 315, 151 N.E. 626 (1926).

attempted resale on the good faith claim that his refusal to pay was justified, is a defensible solution which, in practice, should work to the benefit of both parties while protecting their respective interests.

The benefits to the author are obvious; where his position is ultimately vindicated, the preliminary injunction has preserved his vending monopoly as to the copies in question. The lesser showing required by the *Platt & Munk* court permits an author to act quickly and decisively to protect his copyright before resale has begun. Even though the author might recover damages in a subsequent infringement action against both the manufacturer and the resale buyers (if they in turn attempt to market the copies), the fact remains that without the injunction the author would have lost his right to control or prevent the public distribution of his work.[111] An additional protection for the buyer is that a dishonest seller attempting to elevate a minor contract dispute to the level of a full blown breach (as a basis for resale) will not be able to extort concessions or totally overreach a financially marginal buyer with the threat of resale, when the buyer can easily enjoin the resale by asserting his good faith claim. The traditional requirement that the buyer show the likelihood of ultimate victory, by contrast, puts leverage in the hands of a dishonest manufacturer.[112]

The legitimate seller, on the other hand, also benefits from an early adjudication of a genuine dispute. By notifying the buyer that he intends to resell the goods, the seller establishes a basis for asserting a laches or estoppel defense if the buyer acquiesces in the resale, but later brings an infringement action.[113] If the author moves to enjoin the resale, but cannot establish even a good faith

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[111]See notes 41 and 96 *supra.*

[112]On the other hand, there are factors which might persuade a dishonest manufacturer that an attempted resale is unwise. A resale without justification would constitute criminal infringement. 17 U.S.C. § 104 (Supp. IV 1974), *as amended by* Copyright Act of 1976, Pub. L. No. 94-553, § 506, 90 Stat. 2541. Furthermore, should the author prevail on the issue of contract breach, he could conceivably recover both his contract damages and the manufacturer's resale profits under 17 U.S.C.§ 101 (Supp. I 1971), *as amended by* Copyright Act of 1976, Pub. L. No. 94-553, § 504, 90 Stat. 2541. *See, e.g.,* Sheldon v. Metro-Goldwyn Pictures Corp., 309 U.S. 390 (1940).

[113]It is frequently stated that mere inaction, or silence where there is no affirmative duty to speak, will not raise an estoppel. Lavengood v. Lavengood, 225 Ind. 206, 73 N.E.2d 685 (1947); French v. National Ref. Co., 217 Ind. 121, 26 N.E.2d 47 (1940). In practice, however, equity will measure the facts involved in deciding whether a party's conduct should prevent his recovery. *See, e.g.,* Kelley v. Fisk, 110 Ind. 552, 11 N.E. 453 (1887).

Laches is a particularly appropriate defense to a belated infringement action where the manufacturer must give notice of his intended resale under § 2-706 of the Uniform Commercial Code, or under the notice requirements of the typical artisan's lien statute. See note 15 *supra.* As with estoppel, the successful laches defense will turn on the facts of each case. Harwood v. Railroad Co., 84 U.S. 78 (1872).

claim, the seller may proceed. In either situation the marketability of the goods, and the consequent asking price, are enhanced because the chances of a subsequent infringement action against the resale purchaser have been reduced. Admittedly, a dishonest buyer with at least a colorable claim may be in a position to extract concessions by threatening to enjoin the resale, but this weapon is blunted by the requirement that the buyer post bond.[114] The bonding requirement adequately protects a seller when the value of the goods depends upon timely marketing, as with seasonal items or perishable commodities.

The result of the *Platt & Munk* requirement that the contract issues be quickly adjudicated when the buyer has a colorable claim is that effective restraints have been placed on both the dishonest buyer and the dishonest seller, while eliminating any unwarranted leverage in the hands of either. Concurrently, the early adjudication requirement works to the benefit of both parties if the dispute is legitimate and if the rights asserted by the buyer and seller are substantial enough to justify litigation on self help.

Taken together, the early adjudication requirement and the court's insistence on a "first sale," albeit involuntary, successfully balance the privileges of an author's copyright against the commercial expectations of a manufacturer of copyrighted articles. Whether this delicate balance will survive the new copyright revision, Public Law 94-553, remains to be seen.

IV. Copyright Revision

The drafters of Public Law 94-553 can hardly be said to have written on a *tabula rasa*, since this particular copyright revision is merely the culmination of what must be described as the most tenacious effort at copyright reform in congressional history.

A concentrated attempt to clarify the more confusing aspects of the 1909 Copyright Act and to codify the case law developed under that Act, was begun most recently in 1955 when the Copyright Office initiated thirty-five studies on various facets of copyright law.[115] The report of the Register of Copyright was issued in 1961; and in 1963 the Copyright Office published a preliminary draft of a proposed revision bill. The following year the proposed bill was modified and submitted to both Houses of Congress on July 20, 1964.[116]

Beginning with the 88th Congress, each succeeding Congress had

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[114]See discussion in note 107 *supra*.

[115]Cambridge Research Institute, Omnibus Copyright Revision: Comparative Analysis of the Issues 21 (1973) [hereinafter cited as Cambridge Research Institute, Omnibus Revision].

[116]H.R. 11947, S. 3008, 88th Cong., 2d Sess. (1964).

attempted, but failed, to produce a bill for Presidential signature.[117] The balancing of interests which occurred in *Platt & Munk* represents only one of many potential conflicts between authors and non-authors concerning the numerous uses of the copyright. Any statutory reform "must simultaneously protect the rights of authors, preserve the incentives of publishers, and give the general public access to the new creations."[118] While such a delicate balance may be difficult, it is not impossible. The three most recent proposals, including the new Act, have been strikingly similar, and the previous inability to achieve final passage appears to have centered around the debate over such rapidly changing technologies as cable television, photocopying, and computer programs.[119]

Nonetheless, all of the proposed revisions since 1964 had been in agreement on at least a few basic tenets of copyright philosophy which are relevant to the problem of the unpaid manufacturer of copyrighted goods: the exclusive right of an author to vend copies of his work; the divisibility of the copyright into tangible and intangible components; and the susceptibility of both the tangible and intangible copyright to the demands and obligations of commercial life.[120]

The word "vend" is not used in Public Law 94-553, nor was it used in the proposed revision which preceded the new Act, Senate Bill 1361. Instead, section 106 of the new Act is identical to section 106 of Senate Bill 1361, which enumerates the exclusive rights of an author, including the exclusive right "to distribute copies . . . of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending."[121] Obviously, Public Law 94-553 has improved upon the vague generality of the single word "vend," by specifically setting out the types of conveyances which will be protected by federal statute. Furthermore, those conveyances will now include rental arrangements not included as part of the previous vending monopoly.[122]

However, the exclusive rights granted an author by section 106 of the new Act are subject to specific limitations set out in sections 107 through 117, dealing with fair use, photocopying, cable television, and other uses of the copyright by non-authors which proved a

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[117]*Id;* H.R. 4347, 89th Cong., 1st Sess. (1965); H.R. 2512, 90th Cong., 1st Sess. (1967); S. 543, 91st Cong., 1st Sess. (1969); S. 644, 92d Cong., 1st Sess. (1971); S. 1361, 93d Cong., 1st Sess. (1973).

[118]CAMBRIDGE RESEARCH INSTITUTE, OMNIBUS REVISION, *supra* note 115, at 5.

[119]*Id.* at 22, 23.

[120]Sections 106, 107, 108, and 202, dealing with these concepts have appeared in identical language in the three latest proposed reform bills. See note 117 *supra.*

[121]Copyright Act of 1976, Pub. L. No. 94-553, § 106, 90 Stat. 2541 (1976).

[122]See Bauer et Cie v. O'Donnell, 229 U.S. 1, 13 (1913).

constant source of infringement litigation under the 1909 Copyright Act.[123]

One such limitation on the new right to vend is found in section 109, which replaces the troublesome "but nothing" clause found in section 27 of the 1909 Act.[124] Section 109 gives the owner of a particular copy the right to sell or dispose of the possession of that copy without the author's permission. However, this power to transfer copies free of the vending monopoly is itself limited to those having ownership, not merely possession of the copies.[125] The language of section 109 is an effective response to those litigants who have argued that the reference to lawful possession in the former section 27 permits a bailee, or manufacturer, to resell copyrighted goods without infringing the author's vending monopoly.[126] Notably, the new section 109 is also a codification of two cases which at least one copyright authority considered to be in conflict in their interpretations of the former section 27.[127] One, of course, is *Platt & Munk* which rejected the lawful possession theory of defendant, holding that an author must have made a first sale of the protected copies before the right to vend is terminated — but holding further that such a sale could be voluntary or involuntary by operation of law. The second case, apparently in conflict with *Platt & Munk*, is *United States v. Wells*.[128]

The *Wells* court was faced with the question of whether the defendant, who had a license to make and use as many maps as he wished from a negative supplied by the copyright holder, had infringed the right to vend by selling copies of the map so produced. The license had specifically prohibited the defendant from selling or transferring his copies, but did permit the defendant to reproduce the maps for his own use for "such time as [he] deems fit."[129] In holding that defendant had not infringed the vending monopoly, the *Wells* court pointed out that ownership of the authorized copies was in the defendant, not the copyright holder. While violation of the license might be a breach of contract, it could not be a basis for infringement because the license had failed to state that ownership of any and all copies would remain in the author.[130] The court hinted,

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[123]*See, e.g.*, Teleprompter Corp. v. Columbia Broadcasting System, Inc., 415 U.S. 394 (1974); Williams & Wilkins Co. v. United States, 487 F.2d 1345 (Ct. Cl. 1973), *aff'd*, 420 U.S. 376 (1975); Benny v. Loew's Inc., 239 F.2d 532 (9th Cir. 1956), *aff'd*, 356 U.S. 43 (1958).

[124]17 U.S.C. § 27 (1970) (amended 1976).

[125]Copyright Act of 1976, Pub. L. No. 94-553 § 109, 90 Stat. 2541 (1976).

[126]Platt & Munk Co. v. Republic Graphics, Inc., 315 F.2d 847, 851 (2d Cir. 1963).

[127]NIMMER, *supra* note 22, § 103.323.

[128]176 F. Supp. 630 (S.D. Tex. 1959).

[129]*Id.* at 632.

[130]*Id.* at 634.

and would have been correct in holding, that the terms of the license, and the consideration received for the granting thereof, constituted a "first sale" by the copyright holder of the copies produced by the defendant.[131]

The reliance on ownership in *Wells* could easily be viewed as conflicting with the *Platt & Munk* court's rejection of the "title theory" advanced by the defendant in the latter case.[132] The distinction which makes the two cases compatible is that ownership in *Wells* resulted from the author's transfer of title under the terms of the license, while the title asserted by the defendant in *Platt & Munk* resulted from its position as a seller of goods under the Uniform Sales Act, not from any act of transfer on the part of the author.[133] Hence, Republic's right to resell the goods was contingent on some act of transfer by the author which would give Republic "ownership." The *Platt & Munk* court found this transfer in an author's refusal to pay for the benefits of the manufacturer's performance.[134]

While the language of the new section 109 gives no hint of any qualification of the "ownership" a reselling manufacturer might need to escape an infringement charge, it is submitted that the Committee Report which accompanied the new Copyright Act, and the title of section 109 itself indicate that the author must *transfer* a particular copy before losing the exclusive right to vend that copy.[135] Fortunately, by substituting "transfer" for "first sale," the new Act should avoid the arguments formerly presented by copyright proprietors that "first sale" means voluntarily, for adequate consideration.[136] The terminology of transfer is sufficiently broad to cover conveyances ranging from true sales to the commercial law "involuntary sale" developed in *Wilder v. Kent*,[137] and adopted in *Platt & Munk*. This view is supported by the definition given "transfer" in the new Act, as well as by the provisions of Chapter Two of Public Law 94-553: "Copyright Ownership and Transfer."[138]

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[131]The court suggested:

> [I]t can be argued that the copyright proprietor exhausted his right to vend such copies by granting and selling to the licensee the right to publish them. Thus he would have had the opportunity to exercise one time his exclusive right to vend . . . such copies by the act of granting the license and receiving a consideration therefor.

Id. at 635.

[132]See note 65 *supra* and accompanying text.

[133]315 F.2d at 855.

[134]*Id.*

[135]S. REP. No. 94-473, 94th Cong., 1st Sess. 71 (1975). The title of § 109 is "Limitations on exclusive rights: Effect of transfer of particular copy or phonorecord."

[136]315 F.2d at 854.

[137]15 F. 217 (C.C.W.D. Pa. 1883).

[138]Copyright Act of 1976, Pub. L. No. 94-553, ch. 2, 90 Stat. 2541 (1976).

Section 202 of the new Act restates, in simple terms, the fundamental difference between copyright and the material object to which copyright attaches, leaving unchanged the substance of the present section 27.[139] However, in the immediately preceding section 201, Congress has clarified and changed significantly the former law regarding the transfer of the intangible element of the author's copyright. Section 201(d) states: "The ownership of a copyright may be transferred in whole or in part *by any means of conveyance or by operation of law*, and may be bequeathed by will or pass as personal property by the applicable laws of intestate succession."[140]

The distinct reference in the second clause to testate and intestate succession clearly indicates that the separate preceding reference to transfers by "operation of law" is a codification of the case law holding that intangible copyrights are susceptible to creditor process.[141] In truth, the new Act will liberalize this creditor process because the new section 204 which requires a signed writing to transfer copyright ownership makes an exception for transfers by operation of law.[142] Under existing case law, when a transfer of an author's intangible copyrights was sought, *Ager v. Murray* required personal jurisdiction over the author and a court-compelled transfer, in writing, signed by the author or his court-directed legal representative.[143]

The relaxation of this formality indicates a welcome recognition of the principle enunciated in *Platt & Munk* that a copyright holder should not be able to shield his assets from the ordinary obligations of commercial life just because those assets are, or have had attached to them, intangible rights created by federal statute. The balancing of interests sought to be achieved by the new Act would have been lopsided indeed had it failed to recognize the just demands of those who do business with the author.

How, then, does one explain subsection (e) of the new section 201, prohibiting involuntary transfers—the very heart of *Platt & Munk* and most other transfers "by operation of law"? Subsection (e) reads:

> (e) INVOLUNTARY TRANSFER — When an individual author's ownership of a copyright, or of any of the exclusive rights under a copyright, has not previously been

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[139]CAMBRIDGE RESEARCH INSTITUTE, OMNIBUS REVISION, *supra* note 115, at 222.

[140]Copyright Act of 1976, Pub. L. No. 94-553, § 201(d), 90 Stat. 2541 (1976).

[141]See notes 80-84 *supra*.

[142]This section reads: " A transfer of copyright ownership, *other than by operation of law*, is not valid unless an instrument of conveyance, or a note or memorandum of the transfer, is in writing and signed by the owner of the rights conveyed or his duly authorized agent." Copyright Act of 1976, Pub. L. No. 94-553, § 204(a), 90 Stat. 2541 (1976) (emphasis added).

[143]See note 81 *supra*.

> transferred voluntarily by him, no action by any governmental body or other official or organization purporting to seize, expropriate, transfer or exercise rights of ownership with respect to the copyright, or any of the exclusive rights under a copyright, shall be given effect under this title.[144]

At first blush, subsection (e) reads like a resurrection of century-old case law—with a vengeance. However, the new Committee Report indicates that subsection (e) does not apply to "[t]raditional legal actions, such as bankruptcy proceedings and mortgage foreclosures . . . since the author has, in one way or another, *consented to these legal processes by his actions.*"[145]

Further references in the Committee Report to "foreign authors" and "foreign countries"[146] would indicate that subsection (e) is a careless incorporation of an earlier bill introduced by Senator McClellan in the Ninety-Third Congress.[147] That bill, Senate Bill 1359, was intended to circumvent oppression of dissident authors by the Soviet Union.[148] Though the aim of Senate Bill 1359 is laudable, its emergence in Public Law 94-553 in such general statutory language is an open invitation for specious arguments in creditor process actions. Any court faced with a defense based on subsection (e) should be quick to point out the caveat of the Committee Report, as well as the unequivocal statements in sections 201 and 204 permitting transfers of copyright ownership by operation of law.[149]

When the various sections of the new Act relating to transfers are construed together, it becomes apparent that Congress has adopted the view expressed in existing case law, that authors too must be financially responsible in commercial transactions. The new Act gives an author the right to distribute his work to the public on his own terms, but terminates this right as to particular copies after the author has transferred ownership of those copies to a second party.[150] By giving "transfer" the broad definition it deserves, Congress has streamlined the procedures and eliminated the pitfalls of creditor process against copyright assets.[151] The prohibition in section 201 (e) of involuntary transfers of an author's copyright must be regarded as circumventing the oppression of free speech, not as avoiding the just demands of creditors and unpaid manufacturers.

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[144]Copyright Act of 1976, Pub. L. No. 94-553, § 201(e), 90 Stat. 2541 (1976).

[145]S. REP. No. 94-473, 94th Cong., 1st Sess. 107 (1975) (emphasis added).

[146]*Id.*

[147]S. 1359, 93d Cong., 1st Sess. (1973).

[148]CAMBRIDGE RESEARCH INSTITUTE, OMNIBUS REVISION, *supra* note 115, at 24.

[149]See notes 142-44 *supra* and accompanying text.

[150]See note 125 *supra.*

[151]*See, e.g.*, Sawin v. Guild, 21 F. Cas. 554 (C.C.D. Mass. 1813) (No. 12, 391).

V. Conclusion

Under the 1909 Copyright Act an author has the exclusive right to make the first sale of copies of his work. However, the first sale may be involuntary, as by execution and sheriff's sale, or as the result of state contract or lien law giving an unpaid manufacturer the right to resell copyrighted goods when the author refuses to pay the contract price. Because the breach of contract issue is critical to the right of resale, early resolution of that issue benefits both parties, particularly where the dispute is genuine and the rights involved are substantial. Permitting an author to enjoin a threatened resale on a lesser showing than normally required for obtaining injunctions in non-copyright cases, achieves a delicate but necessary balance between federally created copyrights and state law commercial remedies.

The 1976 Copyright Act, Public Law 94-553, adopts both the rationale and the approach of existing case law in maintaining the balance between authors and non-authors. The extreme positions available to the defaulting buyer and the unpaid manufacturer under prior law will be exorcised by the elimination, respectively, of first sale and lawful possession language used in the 1909 Act. Instead, by adopting the more precise language of "ownership," "transfer," and "transfer by operation of law," the new Act proposes to shift the conflict between buyer and manufacturer to the state law battlefield where it originated.[152]

With the exception of section 201(e), believed to be inapplicable to contract disputes between buyer and seller, the 1976 Act does not directly treat the question whether an unpaid manufacturer is the "owner" of copyrighted goods. Consequently, the procedure adopted by the court in *Platt & Munk* should remain viable. Under the new Act the manufacturer will need to demonstrate his ownership by setting up the buyer's default as an act of transfer. To protect the author against groundless claims and dishonest manufacturers, the resale should be vulnerable to an injunction where the buyer asserts a good faith claim that his refusal to pay is justified. Finally, as in *Platt & Munk*, the issue of breach will be pivotal to the right of resale, and should be resolved as quickly as possible.

Gregory A. Troxell

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[152]Presumably, state law will furnish the definition of ownership, transfers, and conveyances. However, the new Act does define a "transfer of copyright ownership." *See* Copyright Act of 1976, Pub. L. No. 94-553, § 101, 90 Stat. 2541 (1976). Because unpaid manufacturers of copyrighted goods will seldom need to transfer any intangible rights along with the goods, section 101 will not apply. *But see* Stephens v. Cady, 55 U.S. (14 How.) 528 (1852).

Standing To Sue in Private Antitrust Litigation: Circuits in Conflict

I. Introduction

Few areas of the law have received such diverse treatment among the federal courts as that of standing to sue in private antitrust litigation. This continues to occur despite the manifestly unequivocal language of section 4 of the Clayton Act[1] which provides in pertinent part: "Any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States . . . and shall recover threefold the damages by him sustained . . . ."[2]

Notwithstanding the broad language of the Act, the federal courts have developed various tests under which a claimant must fit before he will be allowed to maintain a suit against an alleged antitrust violator.[3] These tests are based on the proximity of the claimant's injury to the alleged violation; therefore, standing is denied if the injury is too remote.

Although much has been written about the various approaches to standing, as well as the recommended interpretations of the Clayton Act,[4] very little has been written about the differing views that each of the eleven federal circuits has developed concerning the standing question, and more importantly, about the serious effects of these variations.

This Note will first briefly examine the various tests used in determining standing; then an analysis of each circuit's approach to the area will follow; and finally, the consequences of this incongruity will be explored in light of the liberal venue and jurisdictional provisions of the Clayton Act.

II. The Tests

Several dichotomies account for the varying degrees of limitation the courts have used in interpreting and applying the Clayton Act;

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[1] 15 U.S.C. §§ 12-27 (1970).

[2] *Id.* § 15.

[3] See notes 14-20 *infra* and accompanying text.

[4] *See, e.g.*, Alioto & Donnici, *Standing Requirements for Anti-Trust Plaintiffs: Judicially Created Exceptions to a Clear Statutory Policy*, 4 U.S.F.L. Rev. 205 (1970); Beane, *Antitrust: Standing and Passing On*, 26 Baylor L. Rev. 331 (1974); Note, *Standing to Sue for Treble Damages Under Section 4 of the Clayton Act*, 64 Colum. L. Rev. 570 (1964).

the first is functional in nature and the others are judicially and statutorily induced.

Operationally, there exists the need for enforcement of the antitrust laws on the one hand, with the need to prevent spurious claims, "windfall recoveries," and the imposition upon businessmen of "liabilities of indefinable scope,"[5] existing on the other (the latter needs emerge primarily from the treble damage provision of the Act). A second dichotomy stems from the broad language of the Act itself, which allows "any person" receiving injury to his business or property from an antitrust violation to maintain a suit, contrasted with the first major judicial decision interpreting and applying the Act[6] which denied the plaintiff standing because he "did not receive any *direct injury* from the alleged illegal acts of the defendant."[7]

A final cause of the variance in approaching the standing issue emanates from the diverse treatment and significance which the lower courts have chosen to assign to the Supreme Court's dicta pertaining to the antitrust laws. For example, many courts[8] adhering to a nonrestrictive view of standing cite *Radovich v. National Football League*[9] in which the Court, referring to the Clayton Act said, "[T]his Court should not add requirements to burden the private litigant beyond what is specifically set forth by Congress in those laws."[10] In marked contrast, courts[11] espousing a restrictive approach to standing often refer to the Supreme Court's decision in *Hawaii v. Standard Oil Co.*[12] in which the Court said, "The lower courts have been virtually unanimous in concluding that Congress did not intend the antitrust laws to provide a remedy in damages for all injuries that might conceivably be traced to an antitrust violation."[13]

The many and diverse tests presently being used to determine a potential litigant's right to sue reflect the lower courts' attempts to resolve the standing issue in the face of the diametrically opposed

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[5]Snow Crest Beverages, Inc. v. Recipe Foods, Inc., 147 F. Supp. 907, 909 (D. Mass. 1956).

[6]Loeb v. Eastman Kodak Co., 183 F. 704 (3d Cir. 1910). A shareholder was denied standing to sue a competitor of the company in which he had an interest.

[7]*Id.* at 709 (emphasis added).

[8]*See, e.g.*, Wilson v. Ringsby Truck Lines, Inc., 320 F. Supp. 699, 703 (D. Colo. 1970). This case allowed several employees to bring suit against their employer for alleged antitrust violations which resulted in a diminution of their wages and other compensation.

[9]352 U.S. 445 (1957).

[10]*Id.* at 454.

[11]*See, e.g.*, Southern Concrete Co. v. United States Steel Corp., 535 F.2d 313, 316 (5th Cir. 1976).

[12]405 U.S. 251 (1972).

[13]*Id.* at 263 n.14.

standards of policy and precedent suggested above. Currently, there are no less than seven approaches to standing, each of which differs from the others only in the degree of remoteness from the violation allowed the claimant. Listed functionally from the most restrictive to the least restrictive, they appear as follows: the "direct injury" approach,[14] the "target area" approach,[15] the "*Karseal* target area" approach,[16] the "proximate target area" approach,[17] the "foreseeable target area" approach,[18] the "zone of interest" approach,[19] and the "unrestricted" approach.[20]

Any appreciable differences between many of the above tests are largely semantic. It is for this reason that an adequate and meaningful analysis of each circuit's approach to standing cannot center around merely defining the above terms and then assigning one approach to each circuit. This is not to say that we cannot gain a general knowledge of the limitations that a certain court will utilize in interpreting section 4 of the Clayton Act by this "labelling" technique, but it is only to suggest that the most profitable determination of each circuit's approach to standing will most likely be made by analyzing the relevant cases of that particular circuit, focusing on the relationship between the parties involved as well as the generic approach emphasized by the particular court.

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[14]*See* Loeb v. Eastman Kodak Co., 183 F. 704 (3d Cir. 1910). Plaintiff was denied standing because he "did not receive any direct injury from the alleged illegal acts of the defendant." *Id.* at 709.

[15]*See* Conference of Studio Unions v. Loew's Inc., 193 F.2d 51 (9th Cir. 1951), *cert. denied*, 342 U.S. 919 (1952). In order to obtain standing a claimant "must show that he is within that area of the economy which is endangered by a breakdown of competitive conditions in a particular industry." *Id.* at 54-55.

[16]*See* Karseal Corp. v. Richfield Oil Corp., 221 F.2d 358 (9th Cir. 1955). "Turning now to the cases concerning the 'target area' . . . the rule is that one who is only *incidentally* injured by a violation of the antitrust laws,—the bystander who was hit but not aimed at,—cannot recover against the violator." *Id.* at 363.

[17]*See* South Carolina Council of Milk Producers, Inc. v. Newton, 360 F.2d 414 (4th Cir.), *cert. denied*, 385 U.S. 934 (1966). "If a plaintiff can show himself within the sector of the economy in which the violation threatened a breakdown of competitive conditions and that he was proximately injured thereby, then he has standing to sue under section 4." *Id.* at 418.

[18]*See* Twentieth Century Fox Film Corp. v. Goldwyn, 328 F.2d 190 (9th Cir.), *cert. denied*, 379 U.S. 880 (1964). In order to recover under section 4 "the plaintiff must show that . . . plaintiff's affected operation was actually in the area which it could reasonably be foreseen would be affected by the conspiracy." *Id.* at 220.

[19]*See* Malamud v. Sinclair Oil Corp., 521 F.2d 1142 (6th Cir. 1975). The test requires that the plaintiff suffer injury in fact and that he be within the zone of interests to be protected by the statute in question.

[20]*See* Wilson v. Ringsby Truck Lines, Inc., 320 F. Supp. 699 (D. Colo. 1970). This case held that no restrictions should be placed on the language of section 4 of the Clayton Act in deciding whether or not a plaintiff should obtain standing.

III. The Circuits

A. First Circuit

The federal courts of the First Circuit very likely adhere to the most narrow construction of section 4 of the Clayton Act utilized by the courts today. In fact, it is improbable that any claimant not in direct competition with the alleged conspirator will have an easy time obtaining standing to sue in the First Circuit.

Generally, the circuit follows the "direct injury" approach, which consistently denies recovery if an intermediary party is present between the plaintiff and the alleged violation. This choice of standing requirement apparently stems from the court's decision in *Snow Crest Beverages, Inc. v. Recipe Foods, Inc.*[21] In *Snow Crest* a supplier was denied standing to bring suit against a competitor of its largest customer. The defendant, by its Sherman and Clayton Act violations, allegedly caused substantial injury to the plaintiff-supplier since the directly injured customer accounted for over ninety percent of plaintiff's yearly sales. In dismissing the complaint, the court laid the groundwork for what was to remain a vary narrow approach to standing in the circuit by saying, "Courts . . . have been reluctant to allow those who were not in direct competition with the defendant to have a private action even though as a matter of logic their losses were foreseeable."[22]

Shortly following the *Snow Crest* decision, the district court had the opportunity to reaffirm its narrow position in *Miley v. John Hancock Mutual Life Insurance Co.*,[23] a case which was to be later affirmed by the First Circuit Court of Appeals. In *Miley*, an insurance broker attempted to bring suit against several insurance companies because of an alleged conspiracy with an insurance commission which resulted in the commission awarding a contract to a competitor of the company which Miley had hoped to represent. The complaint was dismissed because the court held that Miley was not "directly injured by the alleged conspiracy . . . ."[24]

Although subsequent decisions of the circuit have continued to stay with the "direct injury" approach to standing,[25] the harshness of

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[21]147 F. Supp. 907 (D. Mass. 1956).

[22]*Id.* at 909.

[23]148 F. Supp. 299 (D. Mass.), *aff'd per curiam*, 242 F.2d 758 (1st Cir.), *cert. denied*, 355 U.S. 828 (1957).

[24]*Id.* at 302.

[25]*See, e.g.*, Automatic Radio Mfg. Co. v. Ford Motor Co., 35 F.R.D. 198 (D. Mass. 1964), in which defendant's motion for summary judgment was denied solely because a question of fact remained as to whether plaintiff and defendant were in competition with each other; Robinson v. Stanley Home Prods., Inc., 178 F. Supp. 230 (D. Mass.), *aff'd*, 272 F.2d 601 (1959), in which the plaintiff who sold defendant's products was

results which many feel accompanies use of the test is most clearly demonstrated by an analysis of a recent district court opinion of the First Circuit. In *Carroll v. Protection Maritime Insurance Co.*,[26] several fishermen, whose services were effectively boycotted by the defendants' alleged antitrust activity, were denied standing because they were not—as in most boycott situations—in competition with the defendants.

By requiring competitive injury before recovery, the circuit is further narrowing the already restrictive "direct injury" approach, which in its usual application allows standing to those in privity of contract with the alleged conspirators as well as those in direct competition with them. The First Circuit should certainly be the last forum to which a potential antitrust litigant should look when not in direct competition with the defendant, should an alternate forum exist.

B. Second Circuit

Presently, the Second Circuit employs what appears to be a conservative "target area" approach to standing. The "target area" approach focuses on the area of the economy which is affected by the alleged antitrust activity rather than on the relationship between the litigants; a plaintiff to obtain standing need only lie within the affected area. The Second Circuit has generally so restrictively defined the "target area" that, functionally, use of the test within the circuit differs very little in terms of results from use of the "direct injury" approach originally advocated by the circuit.

Until the late 1960's, there was little question that the circuit espoused the "direct injury" test in determining standing.[27] A leading case of the circuit during this period was *Productive Inventions v. Trico Products Corp.*[28] In *Productive Inventions*, a patentee attempted to bring suit against the defendant whose alleged antitrust violations injured the plaintiff's licensee. The licensee was then unable to pay the royalties which a freely competitive market would have commanded. In dismissing the complaint the appellate court stated, "[O]nly those at whom the violation is *directly* aimed, or who have been *directly* harmed may recover."[29]

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found to have sustained no direct injury by reason of the defendant's negotiating directly with the second defendant thus eliminating plaintiff's chance for commissions.

[26]377 F. Supp. 1294 (D. Mass. 1974), *modified*, 512 F.2d 4 (1st Cir. 1975).

[27]*See, e.g.*, New Sanitary Towel Supply v. Consolidated Laundries Corp., 211 F. Supp. 276 (S.D.N.Y. 1962), *adhered to on reargument*, 213 F. Supp. 123 (S.D.N.Y. 1963). To suffer an "actionable wrong" under the antitrust laws "[t]he injury must be direct." *Id.* at 279; Schwartz v. Broadcast Music, Inc., 180 F. Supp. 322 (S.D.N.Y. 1959). "[T]he courts have restricted the right to sue [under Section 4 of the Clayton Act] to those persons who are directly injured . . . ." *Id.* at 327.

[28]224 F.2d 678 (2d Cir. 1955), *cert. denied*, 350 U.S. 936 (1956).

[29]*Id.* at 679 (emphasis added).

During this same period, the district court reached an unusual decision in *Erone Corp. v. Skouras Theatres Corp.*,[30] applying what appeared to be the "direct injury" approach. The court in *Erone* allowed several non-operating owner-lessors of various movie theatres to bring suit against their lessees and other exhibitors for a conspiracy which allegedly reduced the rent received by the owner-lessors. The court felt that the alleged conspirators had acted "to the direct injury of the respective businesses and properties of each of the plaintiffs."[31] The decision is unique in that the "direct injury" approach would normally serve to deprive lessors of the right to sue for damages caused to their leased premises, and was later questioned in *Lieberthal v. North Country Lanes, Inc.*[32] and overlooked in *Skouras Theatres Corp. v. Radio-Keith-Orpheum Corp.*,[33] subsequent district court decisions of the Second Circuit.

The disparity between *Erone* and the *Radio-Keith-Orpheum* and *Lieberthal* decisions is demonstrative of the uncertainty with which private antitrust litigants are faced when attempting to bring suit against a non-competitor, especially when they fall into certain categories regarding which the circuit may not have had any prior decisions. Because of the varying approaches taken by the different circuits, the plaintiff's claim may hinge upon the court's determination of which circuit's decisions should be followed. The court in *Erone* followed the *Congress Building Corp. v. Loew's, Inc.*[34] decision of the Seventh Circuit, whereas the courts in *Lieberthal* and *Radio-Keith Orpheum* chose the *Harrison v. Paramount Pictures, Inc.*,[35] and *Melrose Realty Co., Inc. v. Loew's, Inc.*,[36] line of authority of the Third Circuit.

Since the mid-1960's, the Second Circuit has employed the "target area" approach to standing, at least in name. Operationally, however, the use of the test by the circuit has been closely akin to the "direct injury" test both in definition and results, with few excep-

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[30] 166 F. Supp. 621 (S.D.N.Y. 1957).

[31] *Id.* at 623.

[32] 221 F. Supp. 685 (S.D.N.Y. 1963), *aff'd*, 332 F.2d 269 (2d Cir. 1964). "In this Court, Judge Cashin has declined to follow the Third Circuit and, feeling that there was no direct authority in this Circuit, followed the Congress decision of the Seventh Circuit. Erone Corp. v. Skouras Theatres Corp . . . ." *Id.* at 690. "[M]y conclusion is that this Circuit a landlord may not recover for anti-trust violations affecting the business of his tenant . . . ." *Id.*

[33] 193 F. Supp. 401 (S.D.N.Y. 1961). In attempting to obtain standing "[t]he fact that plaintiffs were the landlords of the theatres avails them nought." *Id.* at 407.

[34] 246 F.2d 587 (7th Cir. 1957) (discussed at text accompanying note 100 *infra*).

[35] 115 F. Supp. 312 (E.D. Pa. 1953), *aff'd*, 211 F.2d 405 (3d Cir.), *cert. denied*, 348 U.S. 828 (1954) (discussed at text accompanying notes 51-56 *infra*).

[36] 234 F.2d 518 (3d Cir.), *cert. denied*, 352 U.S. 890 (1956) (discussed at text accompanying notes 52-56 *infra*).

tions.[37] In *SCM Corp. v. Radio Corp. of America*,[38] for example, the court held that the defendant patentee could not counterclaim for injuries sustained by his licensee, allegedly caused by the plaintiff, because "the [only] people in the 'target area' are plaintiff's competitors . . . ."[39] The need for competitive injury is associated with the "direct injury" approach,[40] not the "target area" approach. In addition to *SCM*, several other more recent decisions of the circuit have intimated that competitive injury continues to be a requisite for standing to sue in the circuit.[41]

The Second Circuit, in addition to denying standing to lessors[42] and patentees,[43] continues to dismiss claims made by suppliers,[44] franchisors[45] and others[46] who suffer injuries that are one step removed from the direct injury. Prospects for a "loosening" of the narrow approach utilized by the Second Circuit appear to be slim in light of past decisions. In a recent case,[47] the court impliedly rejected any movement toward the "foreseeable target area" approach of the Ninth Circuit by denying the plaintiff standing even though its injuries may have been "both immediate and foreseeable . . . ."[48]

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[37]*See, e.g.*, Carnivale Bag Co. v. Slide-Rite Mfg. Corp., 395 F. Supp. 287 (S.D. N.Y. 1975), in which the court expressly rejected a "competitors only" standing requirement in allowing a manufacturer standing to sue for a violation which occurred two steps away on the chain of distribution; Data Digest, Inc. v. Standard & Poor's Corp., 43 F.R.D. 386 (S.D.N.Y. 1967), in which the court gave standing to an employee of a company which was injured by the defendant's alleged antitrust activity.

[38]407 F.2d 166 (2d Cir.), *cert. denied*, 395 U.S. 943 (1969).

[39]*Id.* at 169.

[40]*Cf., e.g.*, Cromar Co. v. Nuclear Materials & Equip. Corp., 395 F. Supp. 198 (M.D. Pa. 1975); Minersville Coal Co. v. Anthracite Export Ass'n, 335 F. Supp. 360 (M.D. Pa. 1971).

[41]*See, e.g.*, GAF Corp. v. Circle Floor Co., 463 F.2d 752 (2d Cir. 1972), *petition for cert. dismissed*, 413 U.S. 901 (1973). "This court has emphasized that, to recover, the plaintiff must allege and prove that the illegal restraint of trade injured his *competitive position* . . . ." *Id.* at 758.

[42]Calderone Enter. Corp. v. United Artists Theatre Circuit, Inc., 454 F.2d 1292 (2d Cir. 1971), *cert. denied*, 406 U.S. 930 (1972).

[43]SCM Corp. v. Radio Corporation of America, 407 F.2d 166 (2d Cir.), *cert. denied*, 395 U.S. 943 (1969).

[44]Billy Baxter, Inc. v. Coca-Cola Co., 431 F.2d 183 (2d Cir. 1970), *cert. denied*, 401 U.S. 923 (1971).

[45]*Id.*

[46]*See, e.g.*, GAF Corp. v. Circle Floor Co., 463 F.2d 752 (2d Cir. 1972), *petition for cert. dismissed*, 413 U.S. 901 (1973), in which a manufacturer was denied standing to sue a major purchaser allegedly engaged in a conspiracy in restraint of trade aimed at the manufacturer.

[47]Long Island Lighting Co. v. Standard Oil Co., 521 F.2d 1269 (2d Cir. 1975), *cert. denied*, 423 U.S. 1073 (1976). In *Long Island* a purchaser was denied standing to sue for injuries suffered as the result of an alleged boycott among suppliers located at a point one step removed from plaintiff along the chain of distribution.

[48]*Id.* at 1274.

C. *Third Circuit*

The Third Circuit has remained one of the most restrictive circuits in finding that plaintiffs have standing, second perhaps only to the First Circuit. The narrow interpretation of the Clayton Act within the decisions of the circuit, in all likelihood, takes place because the case of *Loeb v. Eastman Kodak Co.*,[49] which marked the origin of the "direct injury" test, was decided in this circuit.

Unlike most circuits, which have gradually reduced the restrictions placed upon potential litigants, the Third Circuit in recent cases has actually increased the requirements to an almost "competitors only" approach.[50] This narrowing result occurs in the wake of *Harrison v. Paramount Pictures, Inc.*[51] and *Melrose Realty Co. v. Loew's, Inc.*[52] two Third Circuit decisions which are often equated with each other[53] but which differ dramatically in their implications.

In both *Harrison* and *Melrose*, the unsuccessful claimants were non-operating lessors of movie theatres leased on percentage-of-gross-receipts bases; furthermore, both claimants averred that as the result of illegal conspiracies their lessees were only permitted to show second- and third-run movies which, of course, had the effect of reducing profits made by the lessors under their respective lease agreements. The cases are clearly distinguishable from each other, however, in that one of the alleged conspirators in *Melrose* was the lessee of the theatre, whereas in *Harrison*, only the lessee's competitors were made parties to the action. It has been said that although the *Harrison* decision is squarely in line with the "direct injury" approach,[54] "it is hard to imagine a more direct injury than

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[49]183 F. 704 (3d Cir. 1910) (discussed at text accompanying note 14 *supra*).

[50]*See* Cromar Co. v. Nuclear Materials & Equip. Corp., 395 F. Supp. 198 (M.D. Pa. 1975), in which a supplier was denied standing to sue purchasers which allegedly sought to force supplier out of business; Minersville Coal Co. v. Anthracite Export Ass'n, 335 F. Supp. 360 (M.D. Pa 1971) (discussed at text accompanying note 58 *infra*).

[51]115 F. Supp. 312 (E.D. Pa. 1953), *aff'd*, 211 F.2d 405 (3d Cir. 1954), *cert. denied*, 348 U.S. 828 (1954).

[52]234 F.2d 518 (3d Cir.), *cert. denied*, 352 U.S. 890 (1956).

[53]*See, e.g.*, Calderone Enter. Corp. v. United Artists Theatre Circuit, Inc., 454 F.2d 1292 (2d Cir. 1971), *cert. denied*, 406 U.S. 930 (1972), in which the court cited both cases in support of the proposition "that a non-operating landlord lacks standing to seek treble damages from its tenant and others for alleged antitrust violations which decreased its theatre rentals." *Id.* at 1297; VTR, Inc., v. Goodyear Tire & Rubber Co., 303 F. Supp. 773 (S.D.N.Y. 1969), in which the court equated the two decisions in making a comparison with a third to show the lack of accord lower courts have had in applying a standing doctrine. *Id.* at 782 n.6.

[54]*See* Higginbotham, *Some Judicial Adjustments to the Rights of Recovery Under the Federal Antitrust Laws*, 26 ALA. L. REV. 309 (1974). "The underlying basis for the requirement that a plaintiff in order to have standing must show that a defendant's acts directly injured him was explained . . . in *Harrison* . . . ." *Id.* at 312-13.

the one allegedly suffered by the plaintiff in *Melrose.*"[55] The *Melrose* decision, in fact, "has the effect of creating a 'competitors only' standing doctrine for antitrust actions."[56]

Although the Third Circuit generally follows the "direct injury" approach, allowing both competitors and others directly injured to obtain standing,[57] repercussions of the extremely narrow view taken in *Melrose* continue to pervade opinions of the circuit. The binding effects of *Melrose* can be seen in *Minersville Coal Co. v. Anthracite Export Association,*[58] in which a supplier was denied standing apparently because it was not in direct competition nor in privity of contract with the defendant. Judge Muir expressed the dilemma often faced in the standing area today between precedent and trend when he said:

> Were we not of the opinion that the law of this Circuit is still that laid down in *Melrose Realty,* we would be inclined to follow the approach of the Fourth Circuit in South Carolina Council of Milk Producers, Inc. v. Newton, 360 F.2d 414 (4th Cir. 1966), in which it was held that standing to sue is not limited to those in direct contractual or competitive status with the defendant . . . .[59]

D. Fourth Circuit

Very few standing cases have been decided in the Fourth Circuit, but those that have been suggest that the circuit follows a non-restrictive approach to the issue.

The major decision of the circuit pertaining to standing is *South Carolina Council of Milk Producers, Inc. v. Newton.*[60] In *Newton,* several milk producers sought to bring suit against certain wholesale and retail grocers whose alleged conspiracy had the effect of destroying the market price of milk in the area. The defendants asserted that the milk producers were not their competitors and therefore were too remotely injured to maintain an action under section 4 of the Clayton Act. Judge Bryan disagreed with defendants' assertion and originated the "proximate target area" approach in holding the plaintiffs had standing: "If a plaintiff can show himself within the sector of the economy in which the violation threatened a

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[55]Cromar Co. v. Nuclear Materials & Equip. Corp., 395 F. Supp. 198, 202 (M.D. Pa. 1975).

[56]*Id.*

[57]*See, e.g.,* Kauffman v. Dreyfus Fund, Inc., 434 F.2d 727 (3d Cir. 1970), *cert. denied,* 401 U.S. 974 (1971); Deaktor v. Fox Grocery Co., 332 F. Supp. 536 (W.D. Pa. 1971), *aff'd,* 475 F.2d 1112 (3d Cir. 1973).

[58]335 F. Supp. 360 (M.D. Pa. 1971).

[59]*Id.* at 365.

[60]360 F.2d 414 (4th Cir.), *cert. denied,* 385 U.S. 934 (1966).

breakdown of competitive conditions *and that he was proximately injured thereby,* then he has standing to sue under section 4."[61]

Although the court in *Newton* did not explain the effect that the proximate injury element was to have on the "target area" approach as originated in *Conference of Studio Unions v. Loew's, Inc.*,[62] it appears that it forms the cornerstone of the test. "The pivot of decision presently is whether the defendants' asserted conduct was the proximate cause of the plaintiffs' asserted injury."[63] Functionally, the test may frequently bring the same results as the standard "target area" approach.[64]

Subsequent decisions of the circuit have continued to obtain the liberal results warranted by the *Newton* decision.[65] It is clear that a potential litigant need not fear bringing suit in the Fourth Circuit, as he may in the First, Second, and Third Circuits, merely because he is not in privity of contract or direct competition with the defendant.

E. Fifth Circuit

Until very recently, an antitrust claimant seeking standing in the Fifth Circuit would likely meet with uncertain results if not in direct competition or privity of contract with the defendant. There was a split of authority within the circuit that caused some courts[66] to use the "direct injury" approach and others[67] to utilize the more liberal "proximate target area" approach of the Fourth Circuit. The divergence of approaches was ostensibly the result of the circuit's decisions in *Martens v. Barrett*[68] and *Dailey v. Quality School Plan, Inc.*[69]

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[61]*Id.* at 418 (emphasis added).

[62]193 F.2d 51 (9th Cir. 1951), *cert. denied*, 342 U.S. 919 (1952) (discussed at text accompanying note 15 *supra* and note 124 *infra*).

[63]360 F.2d at 419.

[64]*Compare* Dailey v. Quality School Plan, Inc., 380 F.2d 484 (5th Cir. 1967), in which an employee was granted standing under the "proximate target area" approach, *with* Data Digests, Inc. v. Standard & Poor's Corp., 43 F.R.D. 386 (S.D.N.Y. 1967), in which an employee was permitted to bring suit under the traditional "target area" test.

[65]*See, e.g.*, Midway Enterprises, Inc. v. Petroleum Marketing Corp., 375 F. Supp. 1339 (D. Md. 1974), in which a retailer was found to have standing to sue a supplier of one of his suppliers for alleged violations causing passed on price increases to the plaintiff.

[66]*See, e.g.*, Tugboat, Inc. v. Seafarers Int'l Union, 398 F. Supp. 1131 (S.D. Ala. 1975), *rev'd*, 534 F.2d 1172 (5th Cir. 1976). "In order to have standing to sue . . . a private party must have suffered a *direct injury* to his business or property . . . ." *Id.* at 1132 (emphasis added).

[67]*See, e.g.*, Buckley Towers Condominium, Inc. v. Buchwald, 399 F.Supp. 38 (S.D. Fla. 1975), *aff'd*, 533 F.2d 934 (5th Cir. 1976). "Thus for the plaintiff to have standing, the alleged tie-in must be the *proximate cause* of the plaintiff's liability . . . ." *Id.* at 40 (emphasis added).

[68]245 F.2d 844 (5th Cir. 1957).

[69]380 F.2d 484 (5th Cir. 1967).

In *Martens*, stockholders were denied standing to sue for injuries suffered by the corporation in which they had an interest. The court broadly declared the basis for its decision:

> [I]t is universal that where the business or property allegedly interfered with by forbidden practices is that being done and carried on by a corporation, it is that corporation alone, and not its stockholders (few or many), officers, directors, creditors or licensors, who has a right of recovery, even though in an economic sense real harm may well be sustained . . . .[70]

Subsequent decisions of the circuit greatly broadened the scope and impact of *Martens;* in addition to being used as support for denying standing to stockholders,[71] it became authority for denying the right to employees,[72] a corporate management company[73] and even to several unions.[74]

The counter-trend of decisions in the Fifth Circuit, which adopts the "proximate target area" approach to standing, is the offspring of the *Dailey* decision. In *Dailey,* an employee who was terminated as the alleged results of an illegal merger was given standing to sue the company which had acquired Dailey's former employer. The appellate court, in reversing the district court's decision, emphasized "proximate cause,"[75] as did the *Newton* court of the Fourth Circuit,[76] rather than emphasizing a determination of the "sector of the economy in which the violation threatened a breakdown of competitive conditions . . . ."[77]

Several recent decisions of the circuit have continued to follow the "proximate target area" approach[78] while others have chosen to apply

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[70]245 F.2d at 846 (footnotes omitted).

[71]*See* Mendenhall v. Fleming Co., 504 F.2d 879 (5th Cir. 1974); Schaffer v. Universal Rundle Corp., 397 F.2d 893 (5th Cir. 1968); Campo v. National Football League, 334 F. Supp. 1181 (E.D. La. 1971).

[72]Centanni v. T. Smith & Son, Inc., 216 F. Supp. 330 (E.D. La.), *aff'd,* 323 F.2d 363 (5th Cir. 1963).

[73]Harsh v. CPC Int'l, Inc., 395 F. Supp. 578 (N.D. Tex. 1975).

[74]Tugboat, Inc. v. Seafarers Int'l Union, 398 F. Supp. 1131 (S.D. Ala. 1975), *rev'd,* 534 F.2d 1172 (5th Cir. 1976).

[75]Dailey v. Quality School Plan, Inc., 380 F.2d 484, 487 (5th Cir. 1967).

[76]South Carolina Council of Milk Producers, Inc. v. Newton, 360 F.2d 414 (4th Cir.), *cert. denied,* 385 U.S. 934 (1966).

[77]*Id.* at 418.

[78]Battle v. Liberty Nat'l Life Ins. Co., 493 F.2d 39 (5th Cir. 1974), *cert. denied,* 419 U.S. 1110 (1975), in which several funeral homes and directors were granted standing to sue a funeral insurance company and its subsidiary; Buckley Towers Condominium, Inc. v. Buchwald, 399 F. Supp. 38 (S.D. Fla. 1975), in which a nonprofit condominium corporation was denied standing to sue several condominium developers; Southern Concrete Co. v. United States Steel Corp., 394 F. Supp. 362 (N.D. Ga. 1975), in which a producer of concrete was unable to sue a competitor and its supplier for their alleged

the traditional "target area" test.[79] Use of the "direct injury" approach within the circuit, however, may have come to an end with the recent decision of *Tugboat, Inc. v. Seafarers International Union*.[80] In *Tugboat*, the Fifth Circuit reversed a lower court's holding that several unions did not have standing because they were not in direct competition with the alleged conspirators. The appellate court opted for use of the "proximate target area" approach rather than the "direct injury" approach used by the district court, and found appellants did have standing: "The plaintiff need show only that he is threatened by injury proximately caused by the defendant."[81] This decision may mark the end of the divergent approaches previously used in the circuit and thus may make the Fifth Circuit a more predictable one in which to bring suit for a remote antitrust injury.

F. Sixth Circuit

Notwithstanding that few standing cases have come out of the Sixth Circuit,[82] a recent decision has established the circuit as a pioneer in the modern search for new approaches to private antitrust standing to sue. In *Malamud v. Sinclair Oil Corp.*,[83] the Sixth Circuit Court of Appeals rejected both the "direct injury" and "target area" approaches to standing and allowed an investment company to maintain an antitrust suit against a large oil company even though the two were not competitors. The court said that "as standing doctrines both theories really demand too much from plaintiffs at the pleading stage of a case."[84]

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antitrust violations since it had not been proximately injured thereby. This case also presents an excellent analysis of the application of the "proximate target area" test to several distinct antitrust violations.

[79] Jeffrey v. Southwestern Bell, 518 F.2d 1129 (5th Cir. 1975), in which telephone subscribers' injuries were found not to be within the "target area" of a telephone company's alleged antitrust violations; *In re* Yarn Process Patent Validity & Anti-Trust Litigation, 398 F. Supp. 31 (S.D. Fla. 1975), in which a manufacturer of yarn processing machinery was found not to be within the "target area" of antitrust violations occurring among yarn throwsters and purchasers allegedly limiting the growth of the processing industry; Freeman v. Eastman-Whipstock, Inc., 390 F. Supp. 685 (S.D. Tex. 1975), in which a former employee of two companies allegedly engaging in antitrust violations was found to be within the "target area" of their illegal activity.

[80] 534 F.2d 1172 (5th Cir. 1976), *rev'g* 398 F. Supp. 1131 (S.D. Ala. 1975).

[81] *Id.* at 1174.

[82] In addition to those mentioned in the text, two other recent decisions of the Sixth Circuit have dealt with the standing question. The first, Tennessee Consol. Coal Co. v. UMW, 416 F.2d 1192 (6th Cir. 1969), *cert. denied*, 397 U.S. 964 (1970), followed the Fourth Circuit's "proximate target area" approach. The second, Former Stockholders of Barr Rubber Prods. Co. v. McNeil Corp., 325 F. Supp. 917 (N.D. Ohio 1970), *aff'd*, 441 F.2d 1169 (6th Cir. 1971), merely denied a stockholder the right to sue.

[83] 521 F.2d 1142 (6th Cir. 1975).

[84] *Id.* at 1149.

Prior to *Malamud*, the leading case of the circuit, *Volasco Products Co. v. Lloyd A. Fry Roofing Co.*,[85] in which a supplier of an injured party was denied standing, led some commentators[86] to believe that this circuit espoused the "direct injury" approach. The court in *Malamud* quelled this supposition: "Contrary views notwithstanding, the *Volasco* decision is not a delineation of this Court's view of the doctrine of standing in antitrust suits. . . . [T]he opinion does not have the effect of placing this Circuit among those that adhere to the 'direct injury' approach to standing."[87]

Malamud is the first private antitrust suit in which the "zone of interest" test was used to determine a claimant's standing to bring the action. The test was introduced in 1970 by the United States Supreme Court in two cases[88] brought under the Administrative Procedure Act.[89] The *Malamud* court felt that the Act was sufficiently analogous to section 4 of the Clayton Act to permit the "zone of interest" test to be applied to those seeking standing under the Clayton Act.

The "zone of interest" approach, as used in *Malamud*, is two-pronged in nature; it requires first, "that the plaintiff allege that the defendant caused him injury in fact,"[90] and second, that "the interest sought to be protected . . . [b]e arguably within the zone of interests to be protected or regulated by the statute or constitutional guarantee in question."[91] The court made certain that use of the new test was not to be merely a matter of semantics by undertaking a step-by-step application of the test to the facts of the case.[92]

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[85]308 F.2d 383 (6th Cir. 1962), *cert. denied*, 372 U.S. 907 (1963).

[86]*See, e.g.*, Beane, *Antitrust: Standing and Passing On*, 26 BAYLOR L. REV. 331, 352 (1974). The author has placed a table at the end of his article in which he succinctly expresses what he considers to be each circuit's test of standing based on a leading case from the circuit.

[87]521 F.2d at 1150-51.

[88]Barlow v. Collins, 397 U.S. 159 (1970); Association of Data Processing Serv. Orgs. v. Camp, 397 U.S. 150 (1970).

[89]The pertinent section of the Administrative Procedure Act is 5 U.S.C. § 702, which states: "A person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof."

[90]521 F.2d at 1151.

[91]*Id.*, *quoting* Association of Data Processing Serv. Orgs. v. Camp, 397 U.S. at 153.

[92]The court began its analysis by determining whether the plaintiff had actually suffered an injury and if so whether any nexus existed between this injury and the defendant's alleged violation; this injury and nexus satisfied the first prong of the test. The court then looked to the specific antitrust provisions allegedly violated by the defendant, section 1 of the Sherman Act and section 3 of the Clayton Act, and considered the interests that these provisions were intended to protect. The court concluded the second prong analysis by finding that the plaintiff's injury arguably fell within the area of these interests. 521 F.2d at 1151-52.

At this point it is too early to determine what the effects of *Malamud* will be on subsequent private antitrust suits. To the Sixth Circuit, the decision may mark the beginning of a lenient and exact view of standing if followed in both form and function. Unfortunately, however, for the standing problem in general, the decision will probably add more confusion by its introduction of another standing doctrine into the plethora of tests already in use throughout the federal judiciary. The Seventh Circuit has already given its support to the new approach. In a recent decision,[93] the Seventh Circuit Court of Appeals cited *Malamud* and used the "zone of interest" test in reversing a lower court decision which had denied standing to plaintiffs under the "target area" approach.

G. Seventh Circuit

It is clear from the decisions of the Seventh Circuit that the circuit advocates an unrestricted view of standing. Although the circuit pays lip service to a form of the "target area" approach,[94] a categorical analysis must be made of the claimants who have been awarded standing in the circuit to fully understand the frequency with which the circuit has found standing.

The circuit has continued to advocate a liberal approach to standing since it decided *Roseland v. Phister Manufacturing Co.*[95] in 1942. In *Roseland*, the court allowed a general sales agent to bring suit against a company for which he sold, and in so doing expressed the attitude which has continued to underlie standing decisions of the Seventh Circuit: "The language of the statute [Clayton Act] is general and all inclusive. It includes any person who shall be injured in his business or property."[96] In 1967, the circuit expanded on the *Roseland* decision and allowed an employee of an alleged conspirator to maintain an antitrust action.[97]

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[93]Illinois v. Ampress Brick Co., 536 F.2d 1163 (7th Cir. 1976), *rev'g* 67 F.R.D. 461 (N.D. Ill. 1975) (discussed *infra* at notes 106-13 and accompanying text).

[94]*See, e.g.*, General Beverage Sales Co.—Oshkosh v. East Side Winery, 396 F. Supp. 590 (E.D. Wis. 1975). The court in *East Side Winery* stated, "The Seventh Circuit believes in the 'target area' approach to standing but has formulated its own standards." *Id.* at 596.

> To attain standing, a plaintiff must thus allege that the antitrust violation injured a commercial enterprise of the plaintiff in the area of the economy in which the elimination of competition occurred. Standing is denied, on the other hand, if the claimant's commercial activity occurred outside that area of the economy . . . .

Id., quoting In re Multidistrict Vehicle Air Pollution M.D.L. No. 31, 481 F.2d 122, 128 (9th Cir. 1973).

[95]125 F.2d 417 (7th Cir. 1942).

[96]*Id.* at 419.

[97]Nichols v. Spencer Int'l Press, Inc., 371 F.2d 332 (7th Cir. 1967).

In addition to allowing sales agents and employees standing, the circuit has adopted the liberal view that lessors should not be denied standing.[98] This view, as clearly expressed in *Congress Building Corp. v. Loew's, Inc.*,[99] is contrary to the views of other courts: "We . . . decline to follow the rule laid down by the Third Circuit in the Harrison[100] and Melrose[101] decisions."[102]

Another category of potential antitrust litigants concerning which the circuit has taken a definitive position is that of consumers. In *Commonwealth Edison Co. v. Allis-Chalmers Manufacturing Co.*,[103] the court refused to allow the State of Illinois to intervene in a suit brought by several public utility companies alleging price fixing and other illegal activity on the part of several manufacturers of electrical equipment. The state was bringing the action on behalf of its citizens who allegedly became the true victims of the violations by being forced to pay higher utility rates. The court held that the consumers' injuries were too remote to afford them standing to maintain the action themselves; therefore,the state could not intervene on their behalf.

Several years later, the circuit handed down what appears to be a contradictory decision in *Boshes v. General Motors Corp.*[104] by holding that consumers purchasing automobiles from retailers had standing to sue automobile manufacturers for antitrust violations which raised the cost of the cars to the retailers, an increase which was passed on to the consumers. The apparent contradiction in decisions was first explained away in *Illinois v. Ampress Brick Co.*[105] in which the district court held that although an *ultimate consumer's*[106] injuries are too remote to be afforded Clayton Act relief, standing can be obtained for injuries caused to an *immediate consumer*[107] or a *final consumer.*[108]

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[98]Congress Bldg. Corp. v. Loew's, Inc., 246 F.2d 587 (7th Cir. 1957); Sandidge v. Rogers, 156 F. Supp. 286 (S.D. Ind. 1957), *rev'd on other grounds*, 256 F.2d 269 (7th Cir. 1958).

[99]246 F.2d 587 (7th Cir. 1957).

[100]Harrison v. Paramount Pictures, Inc., 115 F. Supp. 312 (E.D. Pa. 1953), *aff'd*, 211 F.2d 405 (3d Cir.), *cert. denied*, 348 U.S. 828 (1954) (discussed at text accompanying notes 51-59 *supra*).

[101]Melrose Realty Co. v. Loew's, Inc., 234 F.2d 518 (3d Cir.), *cert. denied*, 352 U.S. 890 (1956) (discussed at text accompanying notes 52-59 *supra*).

[102]246 F.2d at 595 (footnotes added).

[103]315 F.2d 564 (7th Cir.), *cert. denied*, 375 U.S. 834 (1963).

[104]59 F.R.D. 589 (N.D. Ill. 1973).

[105]67 F.R.D. 461 (N.D. Ill. 1975), *rev'd*, 536 F.2d 1163 (7th Cir. 1976).

[106]"[One] who obtains a finished product from a middleman that has altered or added to the goods received from the manufacturer." *Id.* at 466.

[107]"[One] who usually acts as a middleman, reselling either the same goods or a refined product to another consumer." *Id.*

[108]"[One] who obtains goods from the manufacturer or from a subsequent

The district court decision in *Ampress Brick* was later reversed in part and the circuit's lenient approach to standing further expanded when the Seventh Circuit held that ultimate consumers, as well as immediate and final consumers, could obtain standing in the circuit if they could prove injury in fact.[109] This injury in fact element became the distinguishing factor between the circuit's holdings in *Ampress Brick* and *Boshes* and that in *Commonwealth Edison.*[110]

Although the *Ampress Brick* opinion will probably not serve to establish any particular test of standing in the Seventh Circuit, since it combined a liberal application of the Sixth Circuit's "zone of interest" test[111] with dictum representing the Ninth Circuit's "foreseeable target area" approach,[112] it certainly does place the circuit among the most liberal in the grant of standing to remotely injured plaintiffs.

H. Eighth Circuit

The few standing decisions decided in the Eighth Circuit indicate that the circuit has adopted the *"Karseal*[113] target area" approach originated in the Ninth Circuit. "Under this approach a private litigant has standing to sue if he 'was within the target area of the illegal practices,' and 'was not only hit, but was aimed at.' "[114]

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consumer, but who in either case acquires the goods in the same condition as originally made and sold by the manufacturer." *Id.*

[109]536 F.2d 1163 (7th Cir. 1976), *rev'g* 67 F.R.D. 461 (N.D. Ill. 1975).

[110]"[T]he decision in *Commonwealth Edison* . . . rests on the failure to prove that the violations damaged the plaintiffs." *Id.* at 1166.

[111]In Malamud v. Sinclair Oil Corp., 521 F.2d 1142 (6th Cir. 1975), the court in using the "zone of interest" test required not only that injury in fact be alleged but also that the causal connection between the violation and the injury be pled. "The first prong of the . . . test is that the plaintiff allege that the defendant caused him injury in fact." *Id.* at 1151. However, in Illinois v. Ampress Brick Co., 536 F.2d 1163 (7th Cir. 1976), although the court required injury in fact, it expressly rejected the need for a showing of causation to obtain standing. "The error in defendants' reading of . . . *Commonwealth Edison* is that they view the failure to show that antitrust violations caused plaintiffs' injury as an element of standing. It is not." *Id.* at 1166.

[112]"[Plaintiffs] have shown that they were 'within the area of the economy which [defendants] reasonably could have or did foresee would be endangered by the breakdown of competitive conditions.' " 536 F.2d at 1167, *quoting In re* Western Liquid Asphalt Cases, 487 F.2d 191, 199 (9th Cir. 1973), *cert. denied sub nom.* Standard Oil Co. v. Alaska, 415 U.S. 919 (1974).

[113]Karseal Corp. v. Richfield Oil Corp., 221 F.2d 358 (9th Cir. 1955) (discussed at text accompanying notes 126-27 *infra*).

[114]Minnesota v. United States Steel Corp., 299 F. Supp. 596, 602 (D. Minn. 1969), *vacated on other grounds*, 438 F.2d 1380 (8th Cir. 1971), *quoting* Karseal Corp. v. Richfield Oil Corp., 221 F.2d at 365.

One major decision of the circuit in which the *Karseal* approach was utilized made it clear that the test does not require the claimant to be in privity of contract with the alleged violator. In *Missouri v. Stupp Brothers Bridge & Iron Co.*,[115] the court allowed the plaintiff standing even though it had had no direct dealings with the defendant. "We can not read into Section 4 of the Clayton Act a requirement of privity . . . ."[116]

Another leading decision of the circuit in which the "*Karseal* target area" approach was utilized is *Sanitary Milk Producers v. Bergjans Farm Dairy, Inc.*[117] The court in *Sanitary* allowed a supplier of milk to sue a competitor of his purchaser for alleged antitrust violations injuring the purchaser. The court distinguished *Sanitary* from decisions of other circuits denying standing to suppliers[118] on the basis that Sanitary was not a raw material supplier selling to a manufacturer, but rather was selling a finished product to its purchaser. This supposedly "demonstrates that there was directness of competition between Bergjans [defendant] and Sanitary . . . ."[119] This reasoning is indicative of the "escape devices" the courts use in the standing area rather than applying standing requirements which they feel are harsh or unfair.

In addition to allowing a supplier to bring suit, the circuit has also granted standing to a lessor to sue for injuries affecting his lessees and the rented premises.[120] As in all circuits, exactly where the line can be drawn in the Eighth Circuit between a sufficient injury and an insufficient injury to obtain standing is unclear; however, it is manifest from recent decisions of the court that the line can be drawn to exclude citizens suing on behalf of their injured municipality.[121]

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[115]248 F. Supp. 169 (W.D. Mo. 1965). In *Stupp Bros.* the plaintiff was allowed standing to sue the defendants, who had sold structured steel to prime contractors who in turn used the steel to make bridges for the plaintiff.

[116]*Id.* at 174.

[117]368 F.2d 679 (8th Cir. 1966).

[118]Volasco Prods. Co. v. Lloyd A. Fry Roofing Co., 308 F.2d 383 (6th Cir. 1962), *cert. denied*, 372 U.S. 907 (1963); Snow Crest Beverages, Inc. v. Recipe Foods, Inc., 147 F. Supp. 907 (D. Mass. 1956).

[119]368 F.2d at 688-89.

[120]Johnson v. Ready Mix Concrete Co., 318 F. Supp. 930 (D. Neb. 1970). This opinion presents an excellent example of the confusion with which the courts are plagued as a result of the many different approaches used in the standing area. For example, the court said in one instance, "[s]tanding to sue under Section 4 is strictly limited to those individuals who have been *directly* injured . . . . This is known as the 'target area' doctrine." *Id.* at 932 (citations omitted).

[121]*See* Cosentino v. Carver-Greenfield Corp., 433 F.2d 1274 (8th Cir. 1970); Ragar v. T. J. Raney & Sons, 388 F. Supp. 1184 (E.D. Ark.), *aff'd*, 521 F.2d 795 (8th Cir. 1975).

I. Ninth Circuit

The Ninth Circuit is the most progressive in dealing with the standing issue. Many legal writers feel that the circuit's "foreseeable target area" approach to standing comes the closest of all tests to the true intent of Congress in drafting, as well as to the view of the Supreme Court in applying, section 4 of the Clayton Act.[122] The test is easily the most nonrestrictive of those used today in determining a claimant's standing to assert an antitrust violation since the injury need not be direct or arise from privity but need only be an objectively foreseeable consequence of the defendant's illegal activity.

The Ninth Circuit became the front-runner of those circuits advocating a broader approach than the "direct injury" test with its decision in *Conference of Studio Unions v. Loew's, Inc.*[123] Although the court in *Loew's* denied the plaintiffs standing, it originated the "target area" approach with its statement:

> [I]n order to state a cause of action under the antitrust laws a plaintiff must show . . . that an act has been committed which harms him. He must show that he is within that area of the economy which is endangered by a breakdown of competitive conditions in a particular industry.[124]

A short time after *Loew's* the "target area" test was modified in *Karseal Corp. v. Richfield Oil Corp.*[125] In *Karseal* a manufacturer was given standing to sue for injuries caused by the defendant to independent retailers who bought plaintiff's products through wholesale distributors. The impact of *Karseal* stretched far beyond the remoteness of the plaintiff from the violation. In *Karseal*, the court concluded "that Karseal was within the target area of the illegal practices of Richfield; that Karseal was not only hit, but was *aimed at*, by Richfield."[126] These words were later to form the origin of the "foreseeable target area" test.

Nine years later, in *Twentieth Century Fox Film Corp. v. Goldwyn*,[127] the court allowed a distributor of motion pictures to sue several buyers of motion pictures who had allegedly colluded for purposes of demanding and receiving lower rates and better terms

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[122]*See, e.g.*, Alioto & Donnici, *Standing Requirements for Antitrust Plaintiffs: Judicially Created Exceptions to a Clear Statutory Policy*, 4 U.S.F.L. REV. 205 (1970). The authors state, "This new approach is significantly more liberal and permissive than the older cases, and as such, is more in line with the intent behind § 4 and the Supreme Court's liberal construction thereof." *Id.* at 212-13.

[123]193 F.2d 51 (9th Cir. 1951), *cert. denied*, 342 U.S. 919 (1952).

[124]*Id.* at 54-55.

[125]221 F.2d 358 (9th Cir. 1955).

[126]*Id.* at 365 (emphasis added).

[127]328 F.2d 190 (9th Cir.), *cert. denied*, 379 U.S. 880 (1964).

from distributors. Referring to the "target area" approach as modified in *Karseal*, the court focused on the words "aimed at" and said:

> [I]n using the words "aimed at" this court did not mean to imply that it must have been a purpose of the conspirators to injure the particular individual claiming damages. Rather, it was intended to express the view that the plaintiff must show that, whether or not then known to the conspirators, plaintiff's affected operation was actually in *the area which it could reasonably be foreseen would be affected* by the conspiracy.[128]

Adding foreseeability to the "target area" test provides an extremely uninhibited approach to standing, as demonstrated by subsequent decisions of the circuit which have granted standing to: an officer of an injured financial institution,[129] governmental agencies not in privity with defendant manufacturers,[130] lessors,[131] suppliers,[132] as well as others[133] whose injuries are remote by most standards. In fact, the only parties denied standing in the Ninth Circuit are those whose injuries are extremely remote under any standards.[134]

J. Tenth Circuit

The Tenth Circuit decisions dealing with the standing question can best be described as polar. Although the court of appeals has espoused the very narrow "direct injury" approach,[135] two recent

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[128]*Id.* at 220 (emphasis added).

[129]Harman v. Valley Nat'l Bank, 339 F.2d 564 (9th Cir. 1964).

[130]Washington v. American Pipe & Constr. Co., 274 F. Supp. 961 (S.D. Cal. 1967).

[131]Hoopes v. Union Oil Co., 374 F.2d 480 (9th Cir. 1967).

[132]Bray v. Safeway Stores, Inc., 392 F. Supp. 851 (N.D. Cal. 1975).

[133]*See, e.g.*, Blankenship v. Hearst Corp., 519 F.2d 418 (9th Cir. 1975), in which a newspaper distributor was given standing to sue a newspaper publisher for an alleged attempt to fix the retail price at which carriers supplied by the distributor could sell to their customers; Mulvey v. Samuel Goldwyn Prods., 433 F.2d 1073 (9th Cir. 1970), *cert. denied*, 402 U.S. 923 (1971), in which the owner of some films was granted standing to sue the purchaser for alleged antitrust violations which served to diminish the owner's potential profit on the sale.

[134]*See, e.g.*, Contreras v. Grower Shipper Vegetable Ass'n, 484 F.2d 1346 (9th Cir. 1973), *cert. denied*, 415 U.S. 932 (1974), in which plaintiffs who farmed lettuce were denied standing to maintain a suit against an association of lettuce sellers for alleged antitrust activity which resulted in a decreased demand for lettuce and thus less work for plaintiffs; *In re* Multidistrict Vehicle Air Pollution M.D.L. No. 31, 481 F.2d 122 (9th Cir.), *cert. denied*, 414 U.S. 1045 (1973), in which farmers were denied standing to sue automobile manufacturers whose alleged antitrust violations resulted in an absence of pollution devices on automobiles supposedly resulting in lower crop yields.

[135]Nationwide Auto Appraiser Serv. v. Association of Cas. & Sur. Cos., 382 F.2d 925 (10th Cir. 1967).

district court opinions have opted for the opposite end of the issue and have used the "foreseeable target area" approach[136] and a completely "unrestricted" approach.[137]

In *Nationwide Auto Appraiser Service, Inc. v. Association of Casualty & Surety Cos.*,[138] the Tenth Circuit Court of Appeals denied standing to a franchisor who attempted to recover for alleged antitrust violations directly affecting his franchisees. In dismissing the complaint, the court based its use of the "direct injury" test on the fact that Congress has made no changes in the law despite the advent and use of the test by other courts:

> The directness rule has been criticized, but it appears to be through the years a practical application of the Clayton Act, and in view of the lapse of time, it must be assumed that it accords with the intention of Congress. . . . If the times have changed, and the needs of business have changed to bring about a need to extend the right of recovery to others, Congress would have so indicated.[139]

Notwithstanding that many subsequent cases[140] of the circuit have reaffirmed use of the narrow approach of *Nationwide*, disposition of the issue within the circuit is not quite as predictable as may appear at first blush. In *Wilson v. Ringsby Truck Lines, Inc.*,[141] for example, the court refused to add any restrictions to the language of the Clayton Act and allowed several employees standing to sue their employer.

A very liberal approach was also taken in *H. F. & S. Co. v. American Standard, Inc.*,[142] in which the plaintiff was allowed standing to sue a franchisor for antitrust activity which allegedly diminished the profit plaintiff received on the sale of a portion of his business. In allowing the claim the court stated, "[T]he defendant could reasonably foresee that plaintiff's operation would be affected in the form of diminution in value received under the new sales agreement."[143] Even though the court in *American Standard* felt the

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[136]H.F. & S. Co. v. American Standard, Inc., 336 F. Supp. 110 (D. Kan. 1972).

[137]Wilson v. Ringsby Truck Lines, Inc., 320 F. Supp. 699 (D. Colo. 1970).

[138]382 F.2d 925 (10th Cir. 1976).

[139]*Id.* at 929.

[140]*See, e.g.*, Reibert v. Atlantic Richfield Co., 471 F.2d 727, 731 (10th Cir.), *cert. denied*, 411 U.S. 938 (1973), in which the plaintiff was denied standing because he had "suffered no direct injury"; Denver Petroleum Corp. v. Shell Oil Co., 306 F. Supp. 289 (D. Colo. 1969). "The gist of the private antitrust action is found in the requirement of *direct injury* to business or property." *Id.* at 306 (emphasis added).

[141]320 F. Supp. 699 (D. Colo. 1970).

[142]336 F. Supp. 110 (D. Kan. 1972).

[143]*Id.* at 116.

decision was in line with *Nationwide*, the "foreseeable target area" approach used in *American Standard* may serve in the future to allow a less restrictive approach to standing by the Tenth Circuit.

K. District of Columbia Circuit

The District of Columbia Circuit has the fewest recent decisions in the standing area. From the two cases analyzed, it appears that the circuit espouses use of the "target area" approach in one form or another.

In one recent decision,[144] the circuit used the "proximate target area" approach of the Fourth Circuit in allowing standing to several plaintiffs who alleged a conspiracy to drive them out of business. The court defined the issue of standing as being "merely a question of whether the pleadings present a triable antitrust issue and allege injury to the plaintiffs which is proximately caused by defendants' conduct . . . ."[145]

In a more recent decision, *Stern v. Lucy Webb Hayes National Training School for Deaconesses and Missionaries*,[146] the district court made use of the "target area" approach as used in *Conference of Studio Unions v. Loew's Inc.*[147] The court in *Stern* denied standing to several former hospital patients who averred a conspiracy between the hospital and several financial institutions, which allegedly increased the price of health services charged by the hospital. "Plaintiffs' activity, as the 'purchasers of hospital health services,' was not within the area of the economy in which the elimination of competition occurred, and thus plaintiffs lack standing to sue."[148]

IV. Conclusion

From the foregoing analyses of the circuits' approaches to standing, it is apparent that a wide degree of variation exists in the area today. What may not be as readily apparent are the present effects that this concurrent utilization of the several different standing doctrines may have on potential litigants in terms of forum shopping, and on the courts in terms of difficulty in trying cases concerning standing.

The mere fact that a potential claimant knows that he may be able to achieve differing results by bringing his claim in different forums does not in and of itself allow forum shopping; there is the need to obtain venue and personal jurisdiction before one can litigate

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[144]Pacific Seafarers, Inc. v. Pacific Far East Line, 48 F.R.D. 347 (D. D.C. 1969).
[145]*Id.* at 351.
[146]367 F. Supp. 536 (D. D.C. 1973).
[147]193 F.2d 51 (9th Cir. 1951), *cert. denied*, 342 U.S. 919 (1952).
[148]367 F. Supp. at 539.

in any forum. In most types of litigation in which the defendant is an individual, these concerns will limit the possible choices of courts in which suit can be maintained to only one or two. However, in antitrust suits brought against corporate defendants, this is not the case; depending on the size of the corporation, there may be several possible districts in which suit can be brought. Section 11 of the Clayton Act provides:

> Any suit, action, or proceeding under the antitrust laws against a corporation may be brought not only in the judicial district whereof it is an inhabitant, but also in any district wherein it may be found or transacts business; and all process in such cases may be served in the district of which it is an inhabitant, or wherever it may be found.[149]

Considering that "venue and personal jurisdiction are virtually congruent"[150] within this section as well as the large number of districts in which the modern corporation frequently is incorporated, found or transacts business, it will usually be the situation that a potential antitrust claimant will have several forums from which to choose in bringing suit under section 4 of the Clayton Act. When we combine this wide choice of possible forums with the diverse doctrines of standing that different courts advocate, who can disagree that a potential antitrust plaintiff one step or more removed from the violation would not be wise to choose carefully the district in which to litigate?

Would it not be foolish for a supplier to take the risk of having his suit summarily dismissed in the First,[151] Second,[152] or Third[153] Circuit if he alternatively could have brought suit in the Fourth,[154] Eighth,[155] or Ninth Circuit?[156] Would not an employee be better off attempting to gain standing in the Fifth[157] or Seventh[158] Circuit than

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[149]15 U.S.C. § 22 (1970).

[150]Pacific Tobacco Corp. v. American Tobacco Co., 338 F. Supp. 842, 844 (D. Ore. 1972).

[151]*See* Snow Crest Beverages, Inc. v. Recipe Foods, Inc., 147 F. Supp. 907 (D. Mass. 1956).

[152]*See* Billy Baxter, Inc. v. Coca-Cola Co., 431 F.2d 183 (2d Cir. 1970), *cert. denied*, 401 U.S. 923 (1971).

[153]*See* Minersville Coal Co. v. Anthracite Export Ass'n, 335 F. Supp. 360 (M.D. Pa. 1971).

[154]*See* South Carolina Council of Milk Producers, Inc. v. Newton, 360 F.2d 414 (4th Cir.), *cert. denied*, 385 U.S. 934 (1966).

[155]*See* Sanitary Milk Producers v. Bergjans Farm Dairy, Inc., 368 F.2d 679 (8th Cir. 1966).

[156]*See* Karseal Corp. v. Richfield Oil Corp., 221 F.2d 358 (9th Cir. 1955).

[157]*See* Dailey v. Quality School Plan, Inc., 380 F.2d 484 (5th Cir. 1967).

[158]*See* Nichols v. Spencer Int'l Press, Inc., 371 F.2d 332 (7th Cir. 1967).

he would be in the Second;[159] or a lessor in the Seventh,[160] Eighth,[161] or Ninth[162] than in the Second[163] or Third?[164] It is equally certain that a final consumer's chances of obtaining standing are much greater in the Seventh Circuit[165] than they are in, for instance, the District of Columbia Circuit.[166]

In general terms, what has emerged today from the disparity with which the circuits have handled the standing question is a situation where, if the choice exists, a potential private antitrust litigant who has been in any way remotely injured would be much wiser to opt for the nonrestrictive views of the Fourth,[167] Sixth,[168] Seventh,[169] Eighth,[170] or Ninth[171] Circuits, than for the uncertain approaches of the Fifth,[172] Tenth,[173] and District of Columbia[174] Circuits. Care should be taken especially to avoid the restrictive views of the First,[175] Second,[176] and Third[177] Circuits if possible.

Finally, to gain an understanding of the problems with which the courts today are faced in dealing with the standing issue and the remotely injured claimant we need only look to a recent decision[178] of the Tenth Circuit in which the court expressed its futile position in applying section 4 of the Clayton Act, "We must confess at the outset that we find antitrust standing cases more than a little confusing and certainly beyond our powers of reconciliation."[179]

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[159]*See* GAF Corp. v. Circle Floor Co., 329 F. Supp. 823 (S.D.N.Y. 1971), *aff'd*, 463 F.2d 752 (2d Cir. 1972), *petition for cert. dismissed*, 413 U.S. 901 (1973).

[160]*See* Congress Bldg. Corp. v. Loew's, Inc., 246 F.2d 587 (7th Cir. 1957).

[161]*See* Johnson v. Ready Mix Concrete Co., 318 F. Supp. 930 (D. Neb. 1970).

[162]*See* Hoopes v. Union Oil Co., 374 F.2d 480 (9th Cir. 1967).

[163]*See* Calderone Enter. Corp. v. United Artists Theatre Circuit, Inc., 454 F.2d 1292 (2d Cir. 1971), *cert. denied*, 406 U.S. 930 (1972).

[164]*See* Melrose Realty Co. v. Loew's, Inc., 234 F.2d 518 (3d Cir.), *cert. denied*, 352 U.S. 890 (1956).

[165]*See* Illinois v. Ampress Brick Co., 536 F.2d 1163 (7th Cir. 1976).

[166]*See* Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries, 367 F. Supp. 536 (D. D.C. 1973).

[167]See notes 60-65 *supra* and accompanying text.

[168]See notes 82-93 *supra* and accompanying text.

[169]See notes 94-112 *supra* and accompanying text.

[170]See notes 113-21 *supra* and accompanying text.

[171]See notes 122-34 *supra* and accompanying text.

[172]See notes 66-81 *supra* and accompanying text.

[173]See notes 135-43 *supra* and accompanying text.

[174]See notes 144-48 *supra* and accompanying text.

[175]See notes 21-26 *supra* and accompanying text.

[176]See notes 27-48 *supra* and accompanying text.

[177]See notes 49-59 *supra* and accompanying text.

[178]Wilson v. Ringsby Truck Lines, Inc., 320 F. Supp. 699 (D. Colo. 1970).

[179]*Id.* at 701.

Antitrust standing law today is truly beyond anyone's "powers of reconciliation"—except those of Congress and of the United States Supreme Court. For only if Congress or the Court takes a definitive position on the issue can resolution possibly take place. Time certainly has not done the job. In fact, with the periodic emergence of new standing doctrines combined with strict adherence to the old, time has only added to the confusion surrounding the area. The answer—until a uniform and definite approach is handed down by the Court or enacted by Congress—comes in the form of an admonition to the potential antitrust litigant suffering indirect injury: Choose your forum carefully!

DAVID L. SWIDER

Appealability of Abstention Orders

> It is most true, that this court will not take jurisdiction if it should not: but it is equally true, that it must take jurisdiction, if it should. The judiciary cannot, as the legislature may, avoid a measure, because it approaches the confines of the constitution. . . . With whatever doubts, with whatever difficulties, a case may be attended, we must decide it, if it be brought before us. *We have no more right to decline the exercise of jurisdiction which is given, than to usurp that which is not given.*[1]

This precept, unlike others penned by Chief Justice Marshall concerning federal jurisdiction, has not weathered the demands of federalism and the complexities of constitutional adjudication. Periodically, however, the dust is brushed aside and this passage re-emerges only to find that those who disturb its repose hasten to add that there is "no such rule today."[2] Such a conclusion, without question, is based upon a reading of the Supreme Court's decisions which established the abstention doctrine[3] under which a federal district court, while retaining jurisdiction,[4] may decline to proceed until the parties have had an opportunity to obtain a decision on questions of state law from the state courts.[5] Thus, the commentator's

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[1]Cohens v. Virginia, 19 U.S. (6 Wheat.) 264, 404 (1821) (Marshall, C.J.) (emphasis supplied).

[2]C. WRIGHT, HANDBOOK OF THE LAW OF FEDERAL COURTS § 52, at 218 (3d ed. 1976) [hereinafter cited as WRIGHT].

[3]Younger v. Harris, 401 U.S. 37 (1971) (absent bad faith, harassment, or a patently invalid state statute, abstention appropriate where federal jurisdiction invoked for purpose of restraining state criminal proceedings); Louisiana Power & Light Co. v. City of Thibodaux, 360 U.S. 25 (1959) (abstention proper in certain diversity actions to allow state court to resolve unsettled question of state law); Burford v. Sun Oil Co., 319 U.S. 315 (1943) (dismissal on abstention grounds appropriate to avoid needless conflict with state's administration of its internal affairs); Railroad Comm'n v. Pullman Co., 312 U.S. 496 (1941) (abstention appropriate to avoid decision of federal constitutional question where case may be disposed of on questions of state law).

[4]Application of the abstention doctrine "does not . . . involve the abdication of federal jurisdiction, but only the postponement of its exercise." Harrison v. NAACP, 360 U.S. 167, 177 (1959); *accord*, Louisiana Power & Light Co. v. City of Thibodaux, 360 U.S. 25 (1959). Cases involving *Younger* abstention are not considered in the Note because dismissal of the federal action is mandated in such cases. *See* MTM, Inc. v. Gonzalez, 420 U.S. 799, 806 n.1 (1975) (concurring opinion).

[5]This permits the federal judgment to be based upon "a complete product of the State, the enactment as phrased by its legislature and as construed by its highest court." Harrison v. NAACP, 360 U.S. 167, 178 (1959).

observation is addressed solely to that part of Marshall's statement which bespeaks a duty to exercise jurisdiction. That jurisdiction, however, is not boundless. The federal courts, both trial and appellate, are courts of limited jurisdiction—their power and authority over cases are derived solely from the Constitution[6] and the Congress.[7] Although there is some scholarly and judicial support for the view that the constitutional grant of judicial power is self-executing,[8] the prevailing view is that it is "dependent for its distribution and organization, and for the *modes of its exercise*, entirely upon the action of Congress."[9]

Clearly the judge-made[10] doctrine of abstention could not have enlarged the scope of that jurisdiction nor sounded the death knell of the rule proscribing the federal judiciary's usurpation of jurisdiction. But is there cause for concern about judicial respect for this second rule in conjunction with appellate review of abstention orders?[11]

Although it might be argued that appealability of abstention orders is a foregone conclusion,[12] the following considerations suggest

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[6]U.S. CONST. art. III, § 2; WRIGHT, *supra* note 2, § 8.

[7]U.S. CONST. art. III, § 1; WRIGHT, *supra* note 2, §§ 10, 11.

[8]WRIGHT, *supra* note 2, § 10, at 27.

[9]Cary v. Curtis, 44 U.S. (3 How.) 236 (1845) (emphasis supplied); *accord*, Lockerty v. Phillips, 319 U.S. 182 (1943).

[10]England v. Louisiana State Bd. of Medical Examiners, 375 U.S. 411 (1964).

[11]Not all district court orders are appealable. Jurisdiction of appeals from certain classes of interlocutory orders, 28 U.S.C. § 1292 (1970), and from all final decisions of the district courts is conferred on the courts of appeals, except where direct review may be had in the Supreme Court, 28 U.S.C. § 1291 (1970).

[12]One writer recently observed that this matter "is not definitively settled," but suggested that:

> The inequities to litigants in not being able to have erroneous orders of abstention overturned may well render abstention orders "final" and appealable under 28 U.S.C. § 1291. . . . Moreover, in cases in which interlocutory injunctions are requested . . . , an order of abstention might be reviewable under 28 U.S.C. § 1292(a)(1) as a refusal of an interlocutory injunction. . . . The same reasoning could allow Supreme Court review of three-judge decisions [under 28 U.S.C. § 1253]. And, of course, certification under 28 U.S.C. 1292(b), and mandamus or prohibition under 28 U.S.C. § 1651, would in any event be available in cases to which they are applicable.

Field, *Abstention in Constitutional Cases: The Scope of the Pullman Abstention Doctrine*, 122 U. PA L. REV. 1071, n.123 (1974) [hereinafter cited as *Abstention in Constitutional Cases*].

The American Law Institute's proposal regarding abstention includes no express provision for review of abstention orders. The All Writs Statute, 28 U.S.C. § 1651, was thought to afford an adequate remedy where entry of the order constituted an abuse of discretion. AMERICAN LAW INSTITUTE, STUDY OF THE DIVISION OF JURISDICTION BETWEEN STATE AND FEDERAL COURTS 291-92 (1969) [hereinafter cited as ALI STUDY]. Professor Field sought to explain the ALI's position by suggesting that it concludes from case law that abstention orders are not reviewable. *Abstention in Constitutional Cases*, *supra* at 1107 n.123. However, to this writer's knowledge, of all the appeals taken from such orders to the courts of appeals, only one has been dismissed for want of

that careful scrutiny of this matter is warranted. First, a federal court has the power to render a judgment only if the case before it is within its jurisdiction. Second, because any proceeding outside the limits prescribed by Congress is coram non judice and any decision or order rendered therein is a nullity,[13] the federal courts are obliged to notice want of jurisdiction. Third, while the Supreme Court has yet to address the issue of the appealability of abstention orders per se, recent decisions of that court and revision of the Three-Judge Court Act have set the stage for an increase in the number of abstention orders[14] and appeals therefrom. Concomitant with the latter is the problem facing appellate courts of determining whether their jurisdiction may be exercised over such orders[15] and, if so, the proper mode or modes for doing so.[16]

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jurisdiction. Public Employees Local 1279 v. Alabama, 453 F.2d 922 (5th Cir. 1972). *See* text accompanying notes 145-47 *infra*. The Supreme Court may have declined jurisdiction over a direct appeal from an abstention order entered by a three-judge court. Daniel v. Waters, 417 U.S. 963 (1974). *See* note 177 *infra*.

[13]Rhode Island v. Massachusetts, 37 U.S. (12 Pet.) 657, 719 (1838).

[14]During the era of the Warren Court (1953-1969), application of the abstention doctrine was narrowly limited. Freda v. Lavine, 494 F.2d 107, 109 (2d Cir. 1974). This prompted one writer to suggest that with the retirement of Mr. Justice Frankfurter in 1962 the abstention doctrine had been left a judicial orphan. Note, *Federal-Question Abstention: Justice Frankfurter's Doctrine in an Activist Era*, 80 HARV. L. REV. 604, 604 (1967). Recent Supreme Court decisions suggest that there has been a rejuvenation of the full implications of the doctrine. Reid v. Board of Educ., 453 F.2d 238, 242 (2d Cir. 1972), *citing* Askew v. Hargrave, 401 U.S. 476 (1971) and Reetz v. Bozanich, 397 U.S. 82 (1970); *see* Boehning v. Indiana State Employees Ass'n, 423 U.S. 6 (1975). Congress not only appears to have been cognizant of this fact, but also to have relied upon it in enacting legislation which largely eliminates the requirement for three-judge courts. S. REP. NO. 94-204, 94th Cong., 2d Sess. 3-4 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3160, 3162-63 [hereinafter cited as S. REP. NO. 94-204]; *see* note 184 *infra*. In commenting upon the Court's recent clarification of the application of the abstention doctrine in *Askew* and *Reetz*, the Senate Committee on the Judiciary noted that "[t]his pattern of decisions clearly precludes the sort of precipitous intrusion in the State legal processes by a single Federal judge that the original Three-Judge Court Act sought to control." S. REP. NO. 94-204, at 8.

[15]During the mid-1960's the courts of appeals referred to cases as having applied the abstention doctrine notwithstanding the fact that the district courts had dismissed the action. *E.g.*, United Steel Workers v. Bagwell, 383 F.2d 492 (4th Cir. 1967). When this is the case, the question of appellate review presents no real problem, for dismissal, with or without prejudice, clearly constitutes a "final decision" from which an appeal may be taken pursuant to 28 U.S.C. § 1291 (1970). United States v. Wallace & Tiernan Co., 336 U.S. 793 (1949).

In 1967 the Court conceded that it "is better practice, in a case raising a federal statutory claim, to retain jurisdiction, rather than to dismiss." Zwickler v. Koota, 389 U.S. 241, 244 n.4 (1967). Because the *Zwickler* rule has been followed even where no federal questions had been raised, *see, e.g.*, Hill v. City of El Paso, 437 F.2d 352, 357 (5th Cir. 1971); Coleman v. Ginsberg, 428 F.2d 767, 770 (2d Cir. 1970), appellate jurisdiction over many abstention orders will no longer clearly lie under section 1291.

[16]Appealability of abstention orders will be considered under 28 U.S.C. § 1291 (1970), *see* text accompanying notes 37-96 *infra;* 28 U.S.C. § 1292(a)(1) (1970), *see* text

Initially this Note will consider *Louisiana Power & Light Co. v. City of Thibodaux*[17] and *Idlewild Bon Voyage Liquor Corp. v. Epstein*,[18] the cases in which the Supreme Court was first confronted by and first considered, although only tangentially, the appealability of abstention orders. Resolution of this issue by the appellate courts will then be examined. Finally, *Idlewild's* teachings will be reconsidered in light of recent Supreme Court dicta.

I. IDLEWILD: AN ENIGMA

The issue of appealability of abstention orders was first raised by the petitioner in *Louisiana Power & Light Co. v. City of Thibodaux*,[19] a case in which the Fifth Circuit reversed an abstention order entered by the district court in an expropriation proceeding after holding that it was appealable under 28 U.S.C. § 1292[(a)](1).[20] In granting certiorari the Court excluded this threshold issue from its scope of review.[21] To do so required it to disregard a statement made by one who had been a member of the Marshall Court.

> However late [an objection that the court has no jurisdiction] may be made in any cause, in an inferior or appellate court of the United States, it must be considered and decided, before any court can move one further step in the cause; as any movement is necessarily the exercise of jurisdiction. . . . If the

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accompanying notes 97-142 *infra;* 28 U.S.C. § 1292(b) (1970), *see* text accompanying notes 143-72 *infra;* and 28 U.S.C. § 1253 (1970), *see* text accompanying notes 173-79 *infra.* Should appeal be improper, the All Writs Act, 28 U.S.C. § 1651 (1970), may provide an alternative means of reviewing a district court's action where there has been an abuse of discretion. See Note, *Supervisory and Advisory Mandamus Under the All Writs Act,* 86 HARV. L. REV. 595 (1973) [hereinafter cited as *Supervisory and Advisory Mandamus*].

[17]360 U.S. 25 (1959), *rev'g* 255 F.2d 774 (5th Cir. 1958).

[18]370 U.S. 713 (1962).

[19]Petition for a Writ of Certiorari at 2, Louisiana Power & Light Co. v. City of Thibodaux, 360 U.S. 25 (1959). The city felt that "the significance of the issue of appealability" had been greatly exaggerated and urged the Court to exclude it from review should it grant the petition. Brief in Opposition to Petition for Certiorari at 4, 10. It reasoned that even if the court of appeals should not have assumed jurisdiction under 28 U.S.C. § 1292, it could have reached the same result by granting a writ of mandamus. *Id.* at 10.

[20]City of Thibodaux v. Louisiana Power & Light Co., 255 F.2d 774, 776 (5th Cir. 1958), *rev'd,* 360 U.S. 25 (1959). *See* text accompanying notes 98-108 *infra.*

[21]Louisiana Power & Light Co. v. City of Thibodaux, 358 U.S. 893 (1958). The Warren Court offered no explanation for excluding this jurisdictional question, but later stated that it granted certiorari "because of the importance of the question in the judicial enforcement of the power of eminent domain under diversity jurisdiction." 360 U.S. at 26.

> law confers the power to render a judgment or decree, then the court has jurisdiction . . . .[22]

Because the Court's jurisdiction had been invoked under 28 U.S.C. § 1254, it was, in a sense, derived from that of the Fifth Circuit. If the latter lacked jurisdiction over the appeal from the abstention order,[23] does it not follow that the Supreme Court would have been without jurisdiction to reverse the judgment of the court of appeals?[24]

In *Idlewild Bon Voyage Liquor Corp. v. Epstein*[25] the Supreme Court was again confronted by this question. Rather than appearing in the pristine form found earlier in *Thibodaux*, the issue of appellate jurisdiction in *Idlewild* was clouded by the compound nature of the order appealed from. Not only had the district judge abstained, he had also denied a motion to convene a three-judge court with leave, however, to renew the motion after the state court determined whether the challenged state statute was applicable to plaintiff.[26] Instead of addressing this matter squarely, the Court contented itself with the following observation: "The Court of Appeals properly rejected the argument that the order of the District Court 'was not final and hence unappealable under 28 U.S.C. §§ 1291, 1292,' pointing out that '[a]ppellant was effectively out of court.' "[27]

Although the matter of appellate review of a district court's refusal to empanel a three-judge court has subsequently been clarified,[28] to this day the meaning of the Court's statement in

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[22]Rhode Island v. Massachusetts, 37 U.S. (12 Pet.) 657, 718 (1838) (Baldwin, J.) (emphasis supplied).

[23]*See* text accompanying notes 101-08 *infra.*

[24]Had the Court dismissed the appeal for want of jurisdiction and instructed the Fifth Circuit to do likewise, the outcome would have been the same—the parties would have been directed to the state courts for resolution of the state law issue.

[25]370 U.S. 713 (1962) (per curiam). In *Idlewild*, petitioners sought to enjoin the state liquor authority from interfering with their business and to obtain a judgment declaring that the state statutes, as applied, were unconstitutional.

[26]Idlewild Bon Voyage Liquor Corp. v. Rohan, 188 F. Supp. 434 (S.D.N.Y. 1960), *appeal dismissed*, 289 F.2d 426 (2d Cir.), *request to convene three-judge court denied*, 194 F. Supp. 3 (S.D.N.Y.), *cert. granted sub nom.* Idlewild Bon Voyage Liquor Corp. v. Epstein, 368 U.S. 812 (1961), *remanded*, 370 U.S. 713, *acq.*, 212 F. Supp. 376 (1962) (abstention improper after lengthy procedural delays), *aff'd sub nom.* Hostetter v. Idlewild Bon Voyage Liquor Corp., 377 U.S. 324 (1964).

[27]370 U.S. at 715 n.2, *quoting* Idlewild Bon Voyage Liquor Corp. v. Rohan, 289 F.2d at 428.

[28]When a single judge refuses to request convention of a three-judge court, but retains jurisdiction, review of his refusal is available in the court of appeals. Schackman v. Arnebergh, 387 U.S. 427 (1967), *citing Idlewild*. In commenting on *Schackman*, Professor Currie wrote that "[i]t was nice to know that *Idlewild* had upheld the power of the Court of Appeals, since the Court in *Idlewild* had not bothered telling us what it was doing." Currie, *Appellate Review of the Decision Whether or Not to Empanel a Three-Judge Federal Court*, 37 U. CHI. L. REV. 159, 161 (1969).

Idlewild, insofar as it pertains to the appealability of abstention orders, remains an enigma.

One need look no further than *Daniel v. Waters*[29] for graphic evidence of the quandary in which a litigant may find himself upon the entry of an abstention order as to the court to which an appeal will lie, the statutory basis for appeal, whether the order is appealable as of right or at the discretion of both the trial and appellate courts, or whether he must petition for a writ of mandamus. In *Daniel* appellants challenged the constitutionality of a Tennessee statute and sought both declaratory and injunctive relief. Upon the entry of an abstention order by a three-judge district court they filed notices of appeal to the Supreme Court and to the court of appeals as well as a motion to intervene and complaint in state court proceedings involving the same statute in which they expressly reserved their federal constitutional claims for federal determination.[30] In their jurisdictional statement appellants argued that the abstention order was "in effect, a denial of [their] motion for a preliminary injunction" within the meaning of 28 U.S.C. § 1253.[31] In their notice of appeal to the Sixth Circuit they asserted that the protective appeal was taken "pursuant to 28 U.S.C. § 1291(a)(1) [*sic*]."[32]

Although the Supreme Court failed to note probable jurisdiction of the direct appeal, it entered the following order: "Judgment vacated and case remanded to the District Court so that it may enter a fresh judgment from which a timely appeal may be taken to the Court of Appeals."[33]

After the three-judge court re-entered its order upon remand, appellants filed a second notice of appeal to the Sixth Circuit in which they asserted that the abstention order was a final order appealable under 28 U.S.C. § 1291, may be reviewable under 28 U.S.C. § 1292(a)(1), and is reviewable under 28 U.S.C. § 1292(b).[34] In the alternative, they requested that the appeal be treated as a petition for a writ of mandamus under 28 U.S.C. § 1651 should the court find the order unappealable.[35]

A review of the decisions emanating from the various circuit courts of appeals reveals a contrariety of views on the subject of the appealability of an abstention order under 28 U.S.C. §§ 1291 and 1292.[36] Does this reflect a state of confusion and uncertainty, or do

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[29]515 F.2d 485 (6th Cir. 1975).

[30]Statement as to Jurisdiction at 7, Daniel v. Waters, 417 U.S. 963 (1974).

[31]*Id.* at 15-16.

[32]*Id.* app., at 31a. One must wonder whether this jurisdictional hybrid was a "typo," a Freudian slip, or a harbinger of the appeal to come.

[33]Daniel v. Waters, 417 U.S. 963 (1974) (mem.).

[34]Brief for Appellants at 7-8, Daniel v. Waters, 515 F.2d 485 (6th Cir. 1975).

[35]*Id.* at 9. *See* text accompanying notes 57-60 *infra* and note 126 *infra*.

[36]Because the abstention doctrine has its roots in federalism, its application in the District of Columbia might be inapposite. Sullivan v. Murphy, 478 F.2d 938, 962

the precedents shape and define more than one road leading to the appellate courts?

II. The Modes of Exercising Appellate Jurisdiction

A. Section 1291—The Final Judgment Rule

The final judgment rule is embodied in the provision of the Judicial Code conferring on the courts of appeals "jurisdiction of appeals from all final decisions of the district courts . . . except where a direct review may be had in the Supreme Court."[37]

Although the Court has been unable to devise an all-encompassing definition of finality,[38] in most instances one may ascertain whether a particular order is or is not final either "from the nature of the order or from a crystallized body of decisions."[39] Nevertheless, there still remain those marginal orders "coming within what might be called the 'twilight zone' of finality."[40] When an appellate court is confronted with such an order, it must determine whether or not the order "falls on the 'finality' side of [the] twilight zone."[41] In so doing the court is not only to give "the requirement of finality . . . a

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n.35 (D.C. Cir. 1973). Thus, the likelihood that the court of appeals for the District of Columbia will have to consider the issue of the appealability of abstention orders appears remote.

[37]28 U.S.C. § 1291 (1970). While the basic rationale of the final judgment rule is conservation of judicial resources, DiBella v. United States, 369 U.S. 121, 124 (1962) ("undue litigiousness and leaden-footed administration of justice" are discouraged by the insistence on finality and prohibition of piecemeal review), the requirement of finality also helps to ensure the correct disposition of a case on the merits and serves to maintain greater respect for the trial courts. Note, *Appealability in the Federal Courts*, 75 Harv. L. Rev. 351, 351-52 (1961) [hereinafter cited as *Appealability in the Federal Courts*].

[38]Dickinson v. Petroleum Conversion Co., 338 U.S. 507, 508 (1950). Generally a final decision is "one which ends the litigation on the merits and leaves nothing for the court to do but execute the judgment." Catlin v. United States, 324 U.S. 229, 233 (1945). However, an order or decision need not necessarily be the last which could possibly be made in a case to come within the meaning of section 1291. Gillespie v. United States Steel Corp., 379 U.S. 148, 152 (1964).

While some definitions relate to the chronology of the proceedings, others focus on the rights of the litigants. *See Appealability in the Federal Courts, supra* note 37, at 353-54. A definition of finality which rests upon an order's concluding all rights that are the subject of the litigation, however, disregards those final orders which do not determine any rights between the parties, such as an order dismissing a complaint without prejudice. Such orders come within the meaning of section 1291 nonetheless. United States v. Wallace & Tiernan Co., 336 U.S. 793 (1949).

[39]Wright, *supra* note 2, § 101, at 505.

[40]Gillespie v. United States Steel Corp., 379 U.S. at 152 (Black, J.).

[41]Dickinson v. Petroleum Conversion Corp., 338 U.S. at 518 (Black, J., dissenting).

'practical rather than a technical construction,' "[42] but also to weigh competing considerations, the most important of which are "the inconvenience and costs of piecemeal review on the one hand and the danger of denying justice by delay on the other."[43]

Should postponement of the exercise of jurisdiction inherent in abstention be equated with an "extended state of suspended animation,"[44] it might be argued that an abstention order is among those marginal orders falling on the finality side of the twilight zone. However, none of those courts which have assumed jurisdiction of an appeal from an abstention order under section 1291 have addressed the order in those terms. At the same time, none have found that relief had been finally denied by the district court.[45] None have undertaken an "evaluation of the competing considerations underlying *all* questions of finality."[46] Not one has explained why it should not heed the caveat that the final judgment rule precludes intrusion by appeal so long as the matter before the district court "remains open, unfinished or inconclusive."[47] Does it follow that all perceive the statement in *Idlewild* as a crystallization of the Court's position on this matter, notwithstanding its obvious lack of clarity?[48]

It was apparently on this basis that the First Circuit held that an "abstention order is clearly appealable as a final order under 28 U.S.C. § 1291."[49] Its decision in *Druker v. Sullivan* was rendered in

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[42]Gillespie v. United States Steel Corp., 379 U.S. at 152.

[43]Dickinson v. Petroleum Conversion Corp., 338 U.S. at 511.

[44]Hines v. D'Artois, 531 F.2d 726, 730 (5th Cir. 1976). *See* note 73 *infra.*

[45]For an order to be "final," it must have the effect of resolving litigation on the merits. Williams v. Mumford, 511 F.2d 363, 366 (D.C. Cir. 1975).

[46]Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 171 (1974) (emphasis supplied).

[47]*Cf.* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 546 (1949) (order no longer open to reconsideration may be considered final for purposes of appeal). Having retained jurisdiction, the district court may vacate its abstention order should the state courts decline to hear the case, *see* Fralin & Waldron, Inc. v. City of Martinsville, 493 F.2d 481, 483 (4th Cir. 1974), or engage in "deliberate judicial footdragging," *see* NAACP v. Gallion, 290 F.2d 337, 342 (5th Cir. 1961).

[48]If *Idlewild* is such a crystal, it would appear to have an internal flaw. "[N]o relief has been finally denied in federal court" where, under *Pullman* abstention, the district court retains jurisdiction while the state-law issues are adjudicated in state court. MTM, Inc. v. Baxley, 420 U.S. 799, 806 n.1 (1975) (concurring opinion), *citing Idlewild* as a case involving *Pullman* abstention. *See* text accompanying notes 180-82 *infra.*

[49]Druker v. Sullivan, 458 F.2d 1272, 1274 n.3 (1st Cir. 1972), *citing Idlewild* and 9 MOORE'S FEDERAL PRACTICE ¶ 110.20[4.-2], at 251 (2d ed. 1973), *aff'g* 334 F. Supp. 861 (D. Mass. 1971). Appellants in *Druker* sought a declaratory judgment that municipal ordinances imposing rent control on certain property were unconstitutional under the Supremacy Clause. The district court stayed proceedings pending state court determination of the validity of the action of the Rent Board. In *Druker* the First Circuit made no mention of the Supreme Court's failure to reject a Fifth Circuit holding that an abstention order was unappealable under the final judgment rule. *See* text accompanying notes 67-69 *infra* and text accompanying notes 19-21 *supra.*

1972. In succeeding years the Ninth, Seventh, and perhaps the Sixth Circuits became part of its rank and file; but not all circuits have joined the march.[50]

In *Moses v. Kinnear*[51] the Ninth Circuit appeared to align itself even more closely with *Idlewild* than had the *Druker* court when it adopted the following rule:

> "If there is no action pending in a state court and the district court stays the action before it and directs the parties to go to the state court to obtain a ruling as to what the state law is, the stay is appealable as a final order under 28 USC § 1291. If injunctive relief is sought in the district court action, such a stay is also appealable as a denial of an injunction under 28 USC § 1292(a)(1)."[52]

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[50]*See* text accompanying notes 62-72 *infra.*

[51]490 F.2d 21 (9th Cir. 1973). In *Moses* declaratory and injunctive relief were sought against the imposition of a state excise tax. The stay appealed from, however, was not the product of the district court's application of the judicially-fashioned abstention doctrine, but rather its conclusion that the action was statutorily barred by the Tax Injunction Act, 28 U.S.C. § 1341 (1970), where adequate state court remedies were available. Because the effect of such a stay is indistinguishable from that of an abstention order, it is not surprising that the Ninth Circuit relied on the same authority as had the *Druker* court to hold the order appealable under 28 U.S.C. §§ 1291, 1292.

Twenty-five years earlier one writer had suggested that Congress might draw upon the provisions of the Tax Injunction Act and the Johnson Act, 28 U.S.C. § 1342 (1970), in order to statutorily deny original federal jurisdiction in cases presenting a claim of federal invalidity in state legislative or administrative action where a "plain, speedy, and efficient remedy" is available in the state courts. Wechsler, *Federal Jurisdiction and the Revision of the Judicial Code,* 13 LAW & CONTEMP. PROB. 216, 229-30 (1948). By incorporating this suggestion in its proposals regarding abstention so as to "require or permit a stay in defined situations in which a state court determination is preferable to federal determination," the American Law Institute sought to eliminate the principal flaws in the present scheme. By adopting clear standards for abstention, there would no longer be uncertainty as to when a state or a federal court is the proper forum; thus, cases would no longer be shuttled from one court to another. ALI STUDY, *supra* note 12, at 284-85.

[52]490 F.2d at 24 (Jameson & Barnes & Choy, J.J.), *quoting* 9 MOORE'S FEDERAL PRACTICE ¶ 110.20 [4.-2], at 251 (2d ed. 1973); *accord,* Rancho Palos Verdes Corp. v. City of Laguna Beach, 547 F.2d 1092 (9th Cir. 1976) (*Pullman* abstention appropriate). *Compare Moses and Rancho Palos Verdes with* Romero v. Weakley, 226 F.2d 399, 400 & n.1 (9th Cir. 1955) ("All the parties also are agreed that the [abstention orders] are appealable. Apart from the agreement we hold these are appealable decisions. Alternatively, appellants sought a writ of mandamus. Our remanding order is, in effect, such a writ."). *But cf.* Sea Ranch Ass'n v. California Coastal Zone Conservation Comm'ns, 537 F.2d 1058, 1061 (9th Cir. 1976) (Wright & Barnes & Browning, J.J.)(abstention order, as modified by three-judge court's denial of preliminary injunction, is appealable under 28 U.S.C. § 1292(a)(1); alternatively jurisdiction lies under the All Writs Act). Implicit in *Sea Ranch* is the holding that prior to its modification, the abstention order was unappealable under 28 U.S.C. §§ 1291, 1292(a)(1). Although he wrote neither opinion, Judge Barnes sat on the panels which decided *Moses* and *Sea Ranch.* After

Although the court of appeals held the order appealable "as a final order" and "as a denial of an injunction"—an interlocutory order in this instance—it does not follow that an order staying an action is final *and* interlocutory at one and the same time.[53] Because these terms are mutually exclusive, to hold that an order is final and therefore appealable under section 1291 precludes holding that it is an interlocutory order of a certain class and therefore appealable under section 1292(a)(1). The converse would obtain as well. Arguably then, before deciding whether a district court order is appealable, an appellate court must determine whether or not it falls on the finality side of the twilight zone, *i.e.*, whether the order is final *or* interlocutory. Once that determination is made, the appealability of a particular order will be governed not by the appellate court, but by the dictates of the jurisdictional provision itself.

The Seventh Circuit has consistently held that an abstention order is appealable under section 1291.[54] In its opinion in *Drexler v. Southwest Dubois School Corp.*[55] the court cited *Idlewild* as primary authority, as had those deciding *Druker* and *Moses*. In none of these opinions did the Court's statement appear, nor was there any attempt to explain its meaning. Only the Seventh Circuit sought to justify its holding.

> Technically this case was not dismissed but merely stayed pending litigation in the state courts and it could be argued that the order is not appealable. However, we think it only logical to consider this order to be a final judgment within the

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calling for the parties to brief the question of the appealability of the abstention order entered in *Rancho Palos Verdes*, the Ninth Circuit indicated that it was "satisfied from the response of counsel that the order was appealable." 547 F.2d at 1093 n.1, *citing Idlewild* and *Moses*.

[53]To so hold would require striking the phrase "appealable as." While at first glance it would appear that the choice of phrasing is simple another way of stating that a stay is a final order and, as such, is appealable under section 1291, upon a second look, it becomes apparent that the reader's attention is being directed away from rather than toward the order itself. Having accomplished this, the writer is at liberty to declare that the order is "appealable as" both a final and an interlocutory order.

[54]Vickers v. Trainor, 546 F.2d 739 (7th Cir. 1976) (abstention inappropriate); Indiana State Employees Ass'n v. Boehning, 511 F.2d 834 (7th Cir. 1974) (abstention inappropriate), *rev'd*, 423 U.S. 6 (1975) (abstention proper where state court construction of relevant state statutes, which may require hearing demanded, may obviate need for deciding constitutional question); Drexler v. Southwest Dubois School Corp., 504 F.2d 836 (7th Cir. 1974).

[55]504 F.2d 836 (7th Cir. 1974) (rehearing in banc) (abstention improper in civil rights action). Plaintiff, a nontenured teacher whose contract had not been renewed, brought an action under the Civil Rights Act, 42 U.S.C. § 1983 (1970). Noting that a paramount state interest was involved, the district court abstained pending resolution of state law issues by the Indiana courts.

meaning of 28 U.S.C. § 1291 and there is ample precedent to support this conclusion.[56]

Idlewild and *Druker* provided Judge Celebrezze ample authority for his belief that an abstention order entered by a single district judge is appealable to the courts of appeals under section 1291.[57] However, for this dissenter to conclude that the Sixth Circuit had jurisdiction over the appeal in *Daniel v. Waters*, it was essential to find support for the proposition that an abstention order entered by a three-judge district court is not directly appealable to the Supreme Court.[58] As he read it, section 1291 not only confers jurisdiction on the courts of appeals, but limits it as well. "Section 1291 extends our jurisdiction to all district court appeals 'except where a direct review may be had in the Supreme Court.' "[59]

The majority in *Daniel* refrained from discussing the basis of its jurisdiction. However, in considering whether the Supreme Court lacked jurisdiction over a direct appeal from the order, the court made a statement which parallels to some extent that appearing in the Court's *Idlewild* opinion. "[T]he abstention order . . . effectively shut the federal courthouse door upon plaintiffs in their search for timely vindication of their federal constitutional claims."[60] Does it follow that the Sixth Circuit would have held that the abstention order entered by a three-judge court was appealable under section 1291 had it considered the question?[61]

Neither the Third nor the Fourth Circuit has discussed the appealability of abstention orders. Instead, each has assumed jurisdiction of an appeal from such an order—the Third in *Howell v.*

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[56]504 F.2d at 838, *citing Idlewild, Moses,* and *Druker*. One must wonder whether the court considered the basis for exercising its jurisdiction when the appeal was initially taken. Drexler v. Southwest Dubois School Corp., 492 F.2d 1245 (7th Cir. 1974) (affirmed without published opinion).

[57]Daniel v. Waters, 515 F.2d 485, 494 n.2 (6th Cir. 1975) (dissenting opinion). *See* text accompanying notes 29-35 *supra.*

[58]*Id.* The dissent found support for his conclusion that the court of appeals, rather than the Supreme Court, has jurisdiction over an appeal from a three-judge court's abstention order in his reading of the Court's order in *Daniel, see* text accompanying note 33 *supra,* and its holding in MTM, Inc. v. Baxley, 420 U.S. 799 (1975). 515 F.2d at 493 & n.1*, 494. *See* note 177 *infra.*

[59]515 F.2d at 494 n.2. In paraphrasing section 1291, Judge Celebrezze failed to mention its finality requirement. His acknowledgment that the order appealed from in *Daniel* merely postpones decision, *i.e.*, it falls short of adjudicating the merits of the case, suggests that it was not final. *Id.* at 493.

[60]515 F.2d at 492.

[61]The proviso excepting those final decisions from the jurisdiction of the courts of appeals where direct appeal to the Supreme Court is available would have been no obstacle to the majority's assuming jurisdiction in *Daniel* under section 1291. From its finding that the challenged statute was patently unconstitutional, it follows that a three-judge court was unnecessary; thus, no direct appeal would lie under 28 U.S.C. § 1253.

Citizens First National Bank[62] and the Fourth in *Fralin & Waldron, Inc. v. City of Martinsville*[63]—without considering this threshold issue. It is not likely that either would follow *Druker*. Support for this premise is derived from a reference in the *Fralin* opinion to "this interlocutory appeal"[64] and from a recent Third Circuit decision in which the court held that a stay order was not a final order appealable under section 1291.[65]

The Fifth Circuit has yet to follow the *Idlewild-Druker* line of cases; instead it has consistently held that an abstention order is not appealable under the final judgment rule.[66] In *City of Thibodaux v.*

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[62]385 F.2d 528 (3d Cir. 1967) (abstention inappropriate where questions involved were purely federal). In *Howell* the state banking commissioner sought to enjoin a national bank from operating a second branch bank on the ground that such was violative of state and federal law. The district court abstained pending institution of state court proceedings.

[63]493 F.2d 481 (4th Cir. 1974) (Clark, J.) (abstention appropriate where determination of federal constitutional question and needless conflict with state's administration of purely state affairs might be avoided). The district court abstained in an action for declaratory judgment, injunctive relief, and damages against the city for its refusal to grant a special use permit.

[64]*Id.* at 482. It seems unlikely that Mr. Justice Clark, sitting by designation on the panel which decided *Fralin* and on the Court which decided *Idlewild*, would use this term unadvisedly. *But see* Amdur v. Lizars, 372 F.2d 103, 105-06 (4th Cir. 1967). The *Amdur* court held that where an order staying proceedings pending termination of similar proceedings in another court amounts to a dismissal, it is appealable as a final order under section 1291. *Fralin* and *Amdur* are readily distinguishable. In *Amdur*, the district judge acknowledged that the practical effect of his order was a dismissal. The *Fralin* court, on the other hand, retained jurisdiction. Thus, Mr. Justice Clark noted that should the state courts decline to hear the case, "it will be soon enough to return to the federal court for disposition of the merits." 493 F.2d at 483.

[65]Cotler v. Inter-County Orthopaedic Ass'n, 526 F.2d 537, 540 (3d Cir. 1975); *accord*, Arny v. Philadelphia Transp. Co., 266 F.2d 869 (3d Cir. 1959). *But see* Joffee v. Joffee, 384 F.2d 632 (3d Cir. 1967) (per curiam) (order similar to that in *Arny* affirmed without discussion of its appealability), *cert. denied*, 390 U.S. 1039 (1968). In *Cotler* defendants were charged, *inter alia*, with violating section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j (1970). Their motion to stay federal proceedings during the pendency of state court actions arising out of the same operative facts was granted by the district court. Appellant's argument that "the indefinite stay . . . has the same practical effect as a final dismissal, and should . . . be treated as such" was rejected. 526 F.2d at 540. Regardless of the duration of the state court actions, the district court must ultimately determine the section 10(b) claim over which it had exclusive jurisdiction. The federal claim may be "old and feeble at the end of the state court litigation, but it will not be dead." *Id.* The *Cotler* court did not attempt to distinguish *Joffee*, but concluded that the per curiam disposition there had not diminished the precedential value of *Arny*.

[66]Gray Line Motor Tours, Inc. v. City of New Orleans, 498 F.2d 293 (5th Cir. 1974); Public Employees Local 1279 v. Alabama, 453 F.2d 922 (5th Cir. 1972); City of Thibodaux v. Louisiana Power & Light Co., 255 F.2d 774 (5th Cir. 1958); *cf.* Mercury Motor Express, Inc. v. Brinke, 475 F.2d 1086 (5th Cir. 1973) (proceedings stayed pending final action by ICC). *But cf.* Hines v. D'Artois, 531 F.2d 726 (5th Cir. 1976) (order staying employment discrimination case pending final EEOC determination on the same charge appealable under section 1291).

Louisiana Power & Light Co.[67] the court of appeals cited *Baltimore Contractors, Inc. v. Bodinger*[68] as authority for its holding that an abstention order is not a final decision within the meaning of section 1291. In *Baltimore Contractors* the Supreme Court had held that an order refusing to stay a suit for an accounting pending arbitration was "an interlocutory order" and as such "could not be called a final decision under § 1291."[69] Because the Court considered that orders granting or denying a stay of proceedings were interlocutory rulings, it was of no moment that the order appealed from in *Thibodaux* stayed the district court action until the Louisiana Supreme Court had been afforded an opportunity to interpret a previously unconstrued state statute upon which the city's expropriation order was based.

In a decision rendered shortly before *Druker*, the Fifth Circuit boldly asserted that "[i]t is *undisputed* that the [abstention] order appealed from is not a final one."[70] In striking contrast is its opinion in *Gray Line Motor Tours, Inc. v. City of New Orleans*,[71] a post-*Druker* decision. In *Gray Line* the majority did not expressly reject the final judgment rule as a means of assuming jurisdiction over an abstention order, but it did so implicitly.[72]

Judge Goldberg, the dissenting member of the *Gray Line* court, abandoned the Fifth Circuit's traditional stance on this issue and joined forces with *Druker* and its ilk.[73] In doing so he noted that

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[67]255 F.2d 774 (5th Cir. 1958). *See* text accompanying note 20 *supra*.

[68]348 U.S. 176 (1955).

[69]*Id.* at 179.

[70]Public Employees Local 1279 v. Alabama, 453 F.2d at 924 (appeal dismissed for want of jurisdiction) (emphasis supplied). Abstention was ordered in this declaratory judgment action challenging the constitutionality of an Alabama statute. After denying a motion for reconsideration of its abstention order, the district court certified the cause for appeal under 28 U.S.C. § 1292(b) (1970). *See* text accompanying notes 144-46 *infra*.

[71]498 F.2d 293 (5th Cir. 1974) (abstention appropriate where issue of state law which had never been decided by state courts might be dispositive of second of plaintiff's allegations). Plaintiff alleged that burdens imposed by the city on it in the operation of its business constituted interference with interstate commerce and that gross receipts tax was invalid under state law and violated the United States Constitution and a federal statute. The district court granted the city's motion for summary judgment on the first claim, but postponed consideration of the second until the state courts had an opportunity to consider the legality of the tax under state law.

[72]On appeal, the majority held that the partial summary judgment on the first claim was not final within the meaning of section 1291 and was, therefore, unappealable in the absence of a Rule 54(b) certification, FED. R. CIV. P. 54(b). *Id.* at 295. To conclude that, in the language of Rule 54(b), the order "adjudicates fewer than all the claims," necessitated the majority's first holding that the entry of the abstention order as to the second claim was not tantamount to a final decision.

[73]498 F.2d at 300 (Goldberg, J., dissenting); *cf.* Hines v. D'Artois, 531 F.2d 726 (5th Cir. 1976) (Goldberg, J.) (order staying employment discrimination case pending final determination by EEOC on same charge appealable as final decision under

"*Idlewild's* teaching, gleaned by both courts and commentators, instructs us[74] that where, as in the present case, no state court action is pending at the time of a federal court's determination to abstain, the abstention order is a final decision appealable under 28 U.S.C. § 1291."[75]

Unlike others who have cited *Idlewild* as authority, Judge Goldberg incorporated portions of the opinions of both the court of appeals and the Supreme Court in his dissenting opinion. First to appear is an excerpt from the opinion of the Second Circuit.

> Appellees' argument that this order was not final and hence unappealable under 28 U.S.C. §§ 1291, 1292 is not well taken. No parallel state actions were pending and there was no state adjudication to await. There was nothing to be done in federal court because the action there had for all intents and purposes concluded. Appellant was effectively out of court—[76]

> Appellees' argument that this order was not final and hence unappealable under 28 U.S.C. §§ 1291, 1292 is not well taken. No parallel state actions were pending and there was no state adjudication to await. There was nothing left to be done in the federal courts because the action there had been for all intents and purposes concluded. Appellant was effectively out of court—any action upon its prayer for injunctive relief was indefinitely postponed under these circumstances. There is no bar on this ground to appealability. See Glen Oaks Utilities, Inc. v. City of Houston, 5 Cir., 1960, 280 F.2d 330.[77]

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section 1291). In *D'Artois*, Judge Goldberg concluded that a practical construction of the requirement of finality requires that "when a plaintiff's action is effectively dead, the order which killed it must be viewed as final. Effective death should be understood to comprehend any extended state of suspended animation." *Id.* at 730. The Fifth Circuit's decision in *D'Artois* suggests that it too may soon be part of the *Idlewild-Druker* fold.

[74][Author's footnote]. Judge Goldberg had cause to choose the word "us." He apparently became aware that there were those who would take issue with the Fifth Circuit on this matter after having sat on the panels which decided Public Employees Local 1279 v. Alabama, 453 F.2d 922, 924 (5th Cir. 1972) ("It is undisputed that the [abstention] order appealed from is not a final one."), and Mercury Motor Express, Inc. v. Brinke, 475 F.2d 1086, 1090 (5th Cir. 1973) ("Plainly, the [order staying the proceedings pending final ICC action] is not appealable as a final order under 28 U.S.C. § 1291.").

[75]498 F.2d at 300 (Goldberg, J., dissenting), *citing Druker* and 9 MOORE'S FEDERAL PRACTICE ¶ 110.20[4.-2], at 251 (2d ed. 1973).

[76]*Id.*, *quoting* the Second Circuit's *Idlewild* opinion.

[77]Idlewild Bon Voyage Liquor Corp. v. Rohan, 289 F.2d at 428.

After indicating that the Supreme Court "explicitly approved this holding,"[78] he quoted a portion of its opinion.

> The Court of Appeals properly rejected the argument that the order of the District Court [was not final].[79]

> The Court of Appeals properly rejected the argument that the order of the District Court "was not final and hence unappealable under 28 U.S.C. §§ 1291, 1292," pointing out that "[a]ppellant was effectively out of court." 289 F.2d at 428.[80]

But what is "this holding"?

Before attempting to answer that question, notice must be taken of the nature of the object of the *Idlewild* appeal. The order confronting the Second Circuit denied a motion to empanel a three-judge court and abstained from considering a renewal of such a motion until the state court had ruled on whether the challenged statute was applicable to plaintiff.

In its opinion the court of appeals appeared to address each segment of the order separately. As to appealability of the abstention order, only upon a careful reading of the quoted excerpt does the court's holding emerge: where an abstention order is entered in an action seeking only declaratory and injunctive relief, it operates as a denial of the latter and is, therefore, appealable under section 1292(a)(1).[81] The court's choice of words[82] and the authority cited[83] make this conclusion inescapable. Furthermore, the court's observation that "[t]here is no bar on *this* ground to appealability"[84] precludes interpretation of the opinion as having held that the abstention order was also appealable under section 1291, for this comment clearly suggests that the court had, in fact, considered that provision as a possible avenue of appeal, but rejected it.

A different result obtained as to the basis for the court's assuming jurisdiction over the other component. Finding that the convening of a three-judge court is mandated where state activity is challenged on

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[78]498 F.2d at 300 (dissenting opinion).

[79]*Id.*, *quoting* the Supreme Court's *Idlewild* opinion.

[80]Idlewild Bon Voyage Liquor Corp. v. Epstein, 370 U.S. at 715 n.2. *But see* Gonzalez v. Automatic Employees Credit Union, 419 U.S. 90, 100 n.19 (1974).

[81]289 F.2d at 428 (by implication). *See* text accompanying note 77 *supra* and notes 120-23 *infra*.

[82]"Appellant was effectively out of court—any action upon its prayer for injunctive relief was indefinitely postponed under these circumstances." 289 F.2d at 428.

[83]Glen Oaks Util., Inc. v. City of Houston, 280 F.2d 330 (5th Cir. 1960). *See* text accompanying notes 117-19 *infra*.

[84]289 F.2d at 428 (emphasis supplied).

constitutional grounds[85] and where the district judge finds that a substantial federal question exists,[86] the Second Circuit apparently concluded that denial of plaintiff's motion to impanel such a court, when conjoined with an order operating as a denial of a preliminary injunction, had the effect of dismissing the complaint.[87] Implicit in this is the holding that such a denial is appealable under section 1291.

It is clear that the Supreme Court held that the court of appeals had jurisdiction over the appeal from the district court order, but it can hardly be said that it "explicitly approved" either or both of the holdings proffered above. Evidence of such approval, if any, must be gleaned from the balance of the Court's per curiam opinion.

Should there be any doubt that the Supreme Court regarded the district court's refusal to convene a three-judge court as a final decision within the meaning of section 1291, it should be dispelled by the following rebuke. "[T]he applicable jurisdictional statute . . . made it impermissible for a single judge *to decide the merits of the case*, either by granting or by withholding relief."[88] This conclusion is further reinforced by its observation that the criteria for convening such a court were "assuredly met" in *Idlewild*.[89] Thus, it may be said with some assurance that the Second Circuit's holding as to the appealability of this segment of the order under section 1291 bears the imprimatur of the Supreme Court.[90]

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[85]*Id.*

[86]*Id.* at 428-29. Implicit in the district court's decision was its finding that a substantial federal question existed. *Id.* at 429 n.2.

[87]*Id.* at 428. *Cf.* Gold v. Lomenzo, 425 F.2d 959, 961 n.2 (2d Cir. 1970) ("Since the order denying a preliminary injunction is appealable to us, 28 U.S.C. § 1292(a), we need not decide whether the denial of a three-judge court, standing alone, would be sufficiently 'final' to enable us to review it under 28 U.S.C. § 1291."). Although the Second Circuit found the order in *Idlewild* to be appealable under 28 U.S.C. §§ 1291, 1292, it held that it had no jurisdiction to entertain the appeal. 289 F.2d at 429.

[88]370 U.S. at 715 (emphasis supplied). The district judge's recognition that abstention involved postponement of jurisdiction, not its abdication, and that a single judge to whom application has been made to convene a three-judge district court could not consider substantive issues presented by the complaint, clearly indicates that he did not perceive his order to be a decision on the merits. Idlewild Bon Voyage Liquor Corp. v. Rohan, 188 F. Supp. at 436-37. Was it imperative that the Court conclude that the district judge had, by the entry of his order in *Idlewild*, decided the case on the merits in order to hold that the order was appealable under section 1291 and thus establish a jurisdictional base for its having granted the petition for writ of certiorari to the Second Circuit since it chose not to take formal action on the petition for a writ of mandamus?

[89]370 U.S. at 715. The standards to be applied by a single district court judge in deciding whether a three-judge court should be convened are: "whether the constitutional question raised is substantial, whether the complaint at least formally alleges a basis for equitable relief, and whether the case presented otherwise comes within the requirements of the three-judge statute." *Id.*

[90]*But see* Gonzalez v. Automatic Employees Credit Union, 419 U.S. 90, 100 n.19 (1974). *See* text accompanying notes 180-82 *infra*.

Inclusion of section 1292 in its quotation of the passage from the opinion of the court of appeals suggests that the Supreme Court similarly endorsed the Second Circuit's holding that the abstention order was appealable as an interlocutory order under that section. Approval of this holding, however, would have been tantamount to a sub silentio overruling of the *Enelow-Ettelson* rule[91] and a concomitant extension of appellate jurisdiction under section 1292(a)(1), neither of which appears to have occurred as a result of *Idlewild*.[92] In this regard, the fact that the Court spoke in terms of the lower court's "withholding relief"[93] rather than "refusing injunctive relief" may be significant, as may be the point at which it chose to end the quotation,[94] and the fact that the Court appeared to limit its scope of review to the propriety of the court's refusal to convene a three-judge court. The only direct reference to abstention in the Court's opinion is the comment that the district judge retained jurisdiction to afford the state courts an opportunity to pass upon the constitutional issues presented.[95] However, a holding that the district judge lacked jurisdiction to order abstention might be inferred from the following statement: "When an application for a statutory three-judge court is addressed to a district court, the court's inquiry is appropriately limited to determining whether [the criteria for convening such a court were met]."[96]

B. Section 1292—Interlocutory Orders

1. Appeals of Right Under Section 1292(a)(1)[97]

a. Action-at-Law Avenue

The Fifth Circuit's view that abstention is an elaborate type of stay paved the way for appellate review of the abstention order entered in *City of Thibodaux v. Louisiana Power & Light Co.*[98] Having rejected section 1291 as an appropriate mode of exercising its appellate jurisdiction,[99] the court nonetheless concluded that the

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[91]*See* text accompanying notes 105-07 *infra*.

[92]To the dismay of some members of the Court the *Enelow-Ettelson* rule appears to be alive and well. *See, e.g.*, Rederi A/B Disa v. Cunard S.S. Co., 389 U.S. 852, 853-54 (1967) (Black, J., dissenting) *denying cert. to* 376 F.2d 125 (2d Cir. 1967) (order staying judicial proceedings pending arbitration not appealable). *See* text accompanying notes 105-07 *infra*.

[93]The term "withholding" does not appear in 28 U.S.C. § 1292(a)(1) (1970).

[94]*Compare* text accompanying note 77 *supra with* that accompanying note 80 *supra*.

[95]370 U.S. at 714.

[96]*Id.* at 715.

[97]28 U.S.C. § 1292(a)(1) (1970). For an overview of the legislative history of this jurisdictional statute, see Baltimore Contractors, Inc. v. Bodinger, 348 U.S. 176, 181 (1955). *See generally Appealability in the Federal Courts*, *supra* note 37, at 367-75.

[98]255 F.2d 774 (5th Cir. 1958) (Jones, J.), *rev'd*, 360 U.S. 25 (1959).

[99]*Id.* at 776. *See* text accompanying notes 66-69 *supra*.

order was appealable as of right under the predecessor of 28 U.S.C. § 1292(a)(1). This section, which operates as an exception to the final judgment rule, confers on the courts of appeals jurisdiction of appeals from interlocutory orders "granting, continuing, modifying, refusing or dissolving injunctions, or refusing to dissolve or modify injunctions, except where direct review may be had in the Supreme Court."[100]

The fact that the order before it was "not an injunction in form"[101] did not deter the court in its effort to bring this order within the penumbra of section 1292(1). Believing that abstention was inappropriate in an expropriation proceeding and that, in any event, the exceptional circumstances which would justify application of that doctrine were absent,[102] the Fifth Circuit found itself in a dilemma—caught as it were between precedents on the one hand which would require it to reverse the distirct court's abstention order[103] and those on the other which would preclude its reviewing that order.[104] A Second Circuit interpretation of the *Enelow-Ettelson* rule,[105] the settled rule governing the appealability of stay orders in federal courts, provided a narrow corridor through which escape was possible.

> "Amid the existing confusion of decisions it is hard to proceed with assurance; but we take it as now settled that the grant, or denial, of a stay in an action that would have been a suit in equity before the fusion of law and equity is now not appealable under § 1292(1) of Title 28; but, if the order is in an action that would have been an action at law before that time, it is appealable."[106]

Because the district court had stayed an action at law, access to the appellate court was assured. This, in turn, enabled the Fifth Circuit to reverse the order of the trial court.

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[100]28 U.S.C. § 1292(a)(1) (1970).

[101]255 F.2d at 776.

[102]*Id.* at 779. Mr. Justice Brennan, writing for the three dissenters, agreed with the Fifth Circuit on both points. Louisiana Power & Light Co. v. City of Thibodaux, 360 U.S. at 32 (Brennan, J., dissenting).

[103]255 F.2d at 777.

[104]*Id.* at 776 n.5, *citing* Baltimore Contractors, Inc. v. Bodinger, 348 U.S. 176 (1955); Ettelson v. Metropolitan Life Ins. Co., 317 U.S. 188 (1942); Enelow v. New York Life Ins. Co., 293 U.S. 379 (1935).

[105]Ettelson v. Metropolitan Life Ins. Co., 317 U.S. 188 (1942); Enelow v. New York Life Ins. Co., 293 U.S. 379 (1935). Operation of this rule converts certain stay orders into orders granting or denying injunctions which are appealable under 28 U.S.C. § 1292(a)(1) (1970). 9 MOORE'S FEDERAL PRACTICE ¶ 110.20[4.-2], at 251 n.13 (2d ed. 1975).

[106]255 F.2d at 777, *quoting* Council of W. Elec. Technical Employees-Nat'l v. Western Elec. Co., 238 F.2d 892, 894 (2d Cir. 1956) (Hand, J.).

Four years later the Fifth Circuit acknowledged that the *Enelow-Ettelson* rule had a second element.

> An order staying or refusing to stay proceedings in the District Court is appealable under § 1292 (a)(1) only if (A) the action in which the order was made is an action which, before the fusion of law and equity, was by its nature an action at law; *and* (B) the stay was sought to permit the prior determination of some *equitable* defense or counterclaim.[107]

Because the abstention order in *Thibodaux* was not based on an equitable defense or cross-bill, but was merely an assertion by the district court of its equitable powers in furthering the harmonious relation between state and federal authority, it failed to satisfy the second of the jurisdictional requisites. Thus, it would appear that the court of appeals should not have considered the matters brought before it by way of appeal in *Thibodaux.*[108]

b. Injunction-Denied Road

In *Gray Line Motor Tours, Inc. v. City of New Orleans,*[109] an action in which injunctive relief was sought, the Fifth Circuit found that the abstention order entered therein did not meet the two-prong *Enelow-Ettelson* test.[110] In this instance, neither requirement was satisfied. Nonetheless, the court found an alternative avenue of appeal—the "injunction-denied" rule: where the abstention order itself has "the effect of denying a preliminary injunction," it is subject to review under section 1292(a)(1).[111] This rule is closely akin to the constructive order doctrine.[112] Both adopt a functional approach to defining the term "injunction" for purposes of appeal under section 1292(a)(1). Both originated in the Fifth Circuit, the injunction-denied rule in *Glen Oaks Utilities, Inc. v. City of Houston*[113] and the constructive

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[107]Jackson Brewing Co. v. Clarke, 303 F.2d 844, 845 (5th Cir. 1962) (emphasis in original).

[108]Recognizing this as a distinct possibility, respondent argued that the court of appeals "could, and should have, *reached the same result by granting a writ of mandamus.*" Brief in Opposition to Petition for Certiorari at 9, Louisiana Power & Light Co. v. City of Thibodaux, 360 U.S. 25 (1959) (emphasis in original).

[109]498 F.2d 293 (5th Cir. 1974). *See* note 71 *supra.*

[110]*See* text accompanying note 107 *supra.*

[111]498 F.2d at 298. The Second Circuit applied this rule in *Idlewild. See* text accompanying note 81 *supra.*

[112]Cotler v. Inter-County Orthopaedic Ass'n, 526 F.2d 537, 541 (3d Cir. 1975). The *Cotler* court coined the phrase "constructive order doctrine" to describe the Fifth Circuit's treatment of a district court's refusal to rule in certain cases as the functional equivalent of the denial of a preliminary injunction. Employing this fiction permits an appellate court to assume jurisdiction over an appeal from an order which was never entered by the lower court.

[113]280 F.2d 330 (5th Cir. 1960) (Jones, J.).

order doctrine in *United States v. Lynd.*[114] While the *Glen Oaks* rule requires the entry of some form of order, the constructive order doctrine is predicated upon the district court's failure to rule on an application for injunctive relief.[115] Courts embracing this doctrine have relied on the effect of the court's silence to justify their exercise of appellate jurisdiction: where no order has been entered by the district court, a plaintiff finds himself in the same position he would have been in had the court ruled against him on his prayer for injunctive relief.[116] A similar rationale clearly underlies the *Glen Oaks* rule.

In *Glen Oaks*, plaintiffs prayed for a temporary restraining order and a permanent injunction. Judge Jones, writing for the court as he had in *Thibodaux*, held that the district court order staying the action was appealable under section 1292(a)(1) because it was "for all practical purposes, a denial of the temporary injunction which was sought."[117] To so hold required Judge Jones to ignore a recent Fifth Circuit holding that an order denying a temporary restraining order is unappealable under section 1292(a)(1).[118] But ignore it he did, as have the courts and commentators who have cited *Glen Oaks* as authority for the proposition that a stay granted in an action seeking only injunctive relief, including a *preliminary injunction*, is appealable under section 1292(a)(1) as the equivalent of a denial of the latter.[119]

Though not citing *Glen Oaks*, as it had ten years earlier in *Idlewild*, the Second Circuit once more employed the rule of that case to exercise jurisdiction over an appeal from an abstention order in *Weiss v. Duberstein.*[120] The court held that since the denial of plaintiffs' motion for summary judgment had the effect of "deny[ing]

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[114]301 F.2d 818 (5th Cir. 1962) (Tuttle, C.J.).

[115]*Id.* at 822. Not every such refusal to rule is appealable under section 1292(a)(1). The standard for determining when the constructive order doctrine may be invoked was announced in NAACP v. Thompson, 321 F.2d 199, 202 (5th Cir. 1963). *See* note 131 *infra* and accompanying text.

[116]Cotler v. Inter-County Orthopaedic Ass'n, 526 F.2d 537 (3d Cir. 1975) (declining to adopt constructive order doctrine but commenting on its rationale).

[117]280 F.2d at 333.

[118]Connell v. Dulien Steel Prod., 240 F.2d 414 (5th Cir. 1957) (Tuttle, J.).

[119]*See* Gray Line Motor Tours, Inc. v. City of New Orleans, 498 F.2d 293 (5th Cir. 1974); Mercury Motor Express, Inc. v. Brinke, 475 F.2d 1086 (5th Cir. 1973); Idlewild Bon Voyage Liquor Corp. v. Rohan, 289 F.2d 426 (2d Cir. 1961); 9 MOORE'S FEDERAL PRACTICE ¶ 110.20[4.-2], at 250 & n.7 (2d ed. 1975).

[120]445 F.2d 1297 (2d Cir. 1971) (abstention improper); *cf.* Sheldon v. Smith, 547 F.2d 768 (2d Cir. 1976) (affirmed district court order denying preliminary injunction and abstaining without discussion of appealability of abstention order); McRedmond v. Wilson, 533 F.2d 757 (2d Cir. 1976) (reversed abstention order entered in civil rights action seeking declaratory and injunctive relief without considering jurisdictional question).

the plaintiffs the temporary injunction which they sought, the portion of the order directing abstention is appealable under 28 U.S.C. § 1292(a)(1)."[121] The fact that the holding in *Weiss* parallels that implicit in the Second Circuit's *Idlewild* decision[122] suggests that its reading of the Supreme Court's opinion in the latter case is at odds with that of the *Druker* court.[123]

But what was the nature of the injunctive relief sought in *Weiss;* was it an action seeking more than a declaration that a state statute was unconstitutional? Because the order appealed from was entered by a single district judge rather than a three-judge court, as would have been required had plaintiffs sought "[a]n interlocutory or permanent injunction restraining the enforcement, operation or execution" of the challenged statute,[124] it would appear that the "temporary injunction" to which the court referred was identical to that sought in *Glen Oaks*—a temporary restraining order, the grant or denial of which is unappealable under section 1292(a)(1).

Gray Line, Weiss, and *Idlewild* are but three examples of the modification of this section by judicial fiat, that is, by an appellate court's treatment of an order staying federal court proceedings as the functional equivalent of the denial of a preliminary injunction. Others are *Moses v. Kinnear,*[125] a case decided by the Ninth Circuit, and *Daniel v. Waters,*[126] a Sixth Circuit case. By focusing upon the purported effect of the district court order, these appellate courts have lost sight of the effect of their having done so: their failure to assume "the responsibility [incumbent upon] all courts to see that no unauthorized entension . . . of jurisdiction, direct or indirect, occurs in the federal system"[127] has resulted in their exercise of jurisdiction

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[121]*Id.* at 1299.

[122]*See* text accompanying note 81 *supra.*

[123]*See* note 49 *supra* and accompanying text.

[124]28 U.S.C. § 2281 (1970) (repealed 1976).

[125]490 F.2d 21 (9th Cir. 1973). *See* text accompanying note 52 *supra. But cf.* Sea Ranch Ass'n v. California Coastal Zone Conservation Comm'ns, 537 F.2d 1058, 1061 (9th Cir. 1976). *See* note 52 *supra.*

[126]515 F.2d 485 (6th Cir. 1975) (by implication). The court's statement that the order "in effect [denied] preliminary injunctive relief" suggests that had the Sixth Circuit considered the basis of its jurisdiction, it would have relied on *Glen Oaks. Id.* at 492 (statement made in conjunction with discussion of Supreme Court's jurisdiction over direct appeal from abstention order entered by three-judge district court). *See* text accompanying notes 30-35 *supra* and 177 *infra.* In *Daniel* the Sixth Circuit vacated the district court's abstention order and remanded the case for entry of an order dissolving the three-judge court and an order granting preliminary injunctive relief. 515 F.2d at 492.

[127]Baltimore Contractors, Inc. v. Bodinger, 348 U.S. 176, 181 (1955). Because modification of appellate jurisdiction under section 1292 falls within the legislative domain alone, the Supreme Court lacks authority to approve or declare judicial modification of the provision conferring jurisdiction on the courts of appeals over certain interlocutory orders. *Id.*

over appeals from orders otherwise unappealable under section 1292(a)(1).

While it may be logical to consider that a stay of an action for injunctive relief operates as a denial of a preliminary injunction, even if usurpation of jurisdiction is not an issue, it does not follow that the entry of every such order should be automatically appealable.[128] As a threshold matter the appellate court should determine whether the trial court's entry of the stay order is tantamount to a "denial" of a preliminary injunction.[129] But courts intent upon assuming jurisdiction of appeals from abstention orders under section 1292(a)(1) have failed to do so.[130] To date, no standard has been propounded by which to make such a determination, although the standard used to screen appeals brought under the constructive order doctrine might be adapted for that purpose.

> If the posture of the case is such that the plaintiff's rights have been so clearly established that a failure of the trial court to grant the injunctive relief would be set aside by an appellate court as an abuse of discretion, then for the trial court [to enter an abstention order in lieu of] an order either granting or denying the relief sought may be considered . . . to be such interlocutory order refusing relief as to come within the purview of Section 1292.[131]

These same courts appear similarly disinclined to address other problems inherent in the functional approach to appealability under the *Glen Oaks* rule, such as the need for practical assessment of each

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[128]*Cf.* NAACP v. Thompson, 321 F.2d 199, 202 (5th Cir. 1963) (Tuttle, C.J.) ("[I]t does not follow that every failure of a trial court to grant a temporary injunction is tantamount to a 'refusal' of such injunctive relief."). *Thompson's* author found it necessary to limit the applicability of the constructive order doctrine which he had a hand in creating in *United States v. Lynd. See* text accompanying notes 112-16 *supra.*

[129]*Id.*

[130]*See, e.g.,* Daniel v. Waters, 515 F.2d 485 (6th Cir. 1975). Although plaintiffs sought preliminary and permanent injunctive relief against the enforcement of the challenged state statute in *Daniel,* they failed to allege immediate and irreparable injury or take any practical step toward obtaining a preliminary injunction. Motion to Dismiss or Affirm at 6-7, Daniel v. Waters, 417 U.S. 963 (1974). Because the district court found that "State determination of these matters then, will be completed well in advance of the effective date of the amendment and, therefore, well in advance of the contemplated constitutional infringements alleged," Jurisdictional Statement at 24a, respondents argued that the abstention order should not be considered a denial of a preliminary injunction; and even if it were, that under the circumstances, it could "not be seriously maintained that the denial of a preliminary injunction was improper," Motion to Dismiss or Affirm at 7.

[131]NAACP v. Thompson, 321 F.2d 199, 202 (5th Cir. 1963). The words appearing within brackets in the proposed standard for the *Glen Oaks* rule were substituted for the phrase "to fail to enter" in the Fifth Circuit's standard for the constructive order doctrine, as stated in *Thompson.*

case[132] and for determining whether the exercise of appellate jurisdiction in such cases is congruent with the purpose underlying the adoption of section 1292(a)(1).[133]

As a general rule an appellate court will forgo consideration of the merits of a case before it on interlocutory appeal, except to the extent necessary to decide the matter supplying appellate jurisdiction.[134] Those courts relying on *Glen Oaks* to assume jurisdiction over an appeal from an abstention order have dispensed with this rule. They have found it to be a rule of orderly judicial administration rather than a limitation on the court's power.[135] As a consequence, if any consideration is given to whether the district court should have granted a preliminary injunction, it is incidental to the court's discussion of whether abstention was appropriate.

c. No Road

Whether the Third and Fourth Circuits would find an abstention order appealable under section 1292(a)(1) is purely a matter for conjecture at this point. Only the Third Circuit has expressly rejected treating a stay order as the denial of injunctive relief;[136] and unlike those circuits which have embraced the *Glen Oaks* rule, this circuit has indicated that were it to adopt the functional approach at some future date, compliance with the historical *Enelow-Ettelson* action-at-law rule would still be essential.[137]

From this it follows that the Third Circuit would dismiss an appeal from an abstention order entered in an action wherein the

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[132]Appellate analysis should entail consideration of whether preliminary evaluation of the merits of the prayer for injunctive relief or evaluation of whether such relief was warranted at any point in the proceedings was implicit in the district court's action. Williams v. Mumford, 511 F.2d 363, 370 (D.C. Cir. 1975); Dellinger v. Mitchell, 442 F.2d 782, 789 (D.C. Cir. 1971).

[133]The legislative history of section 1292 does not reveal the underlying reasons for excepting certain interlocutory orders from the final judgment rule; nonetheless, the Court concluded that it was enacted to prevent "serious, perhaps irreparable" injury if not corrected without delay. Baltimore Contractors, Inc. v. Bodinger, 348 U.S. 176, 181 (1955). Applying the "serious, perhaps irreparable" harm standard to abstention orders led one writer to conclude that there could ordinarily be no such showing as the result of the entry of such an order. "[I]f such orders are erroneously issued, there will not be irreparable injury, but rather the ordinary delays and expenses that result from reversible interlocutory orders." Note, *Appealability of Stay Orders in the Federal Courts*, 47 MINN. L. REV. 1099, 1109 (1963).

[134]Time, Inc. v. Ragano, 427 F.2d 219 (5th Cir. 1970).

[135]Gray Line Motor Tours, Inc. v. City of New Orleans, 498 F.2d 293, 298 (5th Cir. 1974); *see* Weiss v. Duberstein, 445 F.2d 1297 (2d Cir. 1971); Idlewild Bon Voyage Liquor Corp. v. Rohan, 289 F.2d 426 (2d Cir. 1961); *cf.* Sea Ranch Ass'n v. California Coastal Zone Conservation Comm'ns, 537 F.2d 1058 (9th Cir. 1976) (abstention order, as modified by denial of preliminary injunction, is appealable under section 1292(a)(1)).

[136]Cotler v. Inter-County Orthopaedic Ass'n, 526 F.2d at 541. *See* note 65 *supra*.

[137]526 F.2d at 540-41.

relief sought sounds primarily in equity. *Howell v. Citizens First National Bank*[138] was such an action. On appeal the Third Circuit reversed the lower court order without considering whether it had jurisdiction to do so.

In *Fralin & Waldron, Inc. v. City of Martinsville*[139] the Fourth Circuit assumed jurisdiction of an "interlocutory appeal" from an abstention order entered in an action for a declaratory judgment, injunctive relief, and damages without discussion of the mode by which its power was being exercised. Since no reference was made to its jurisdiction's being invoked pursuant to section 1292(b),[140] can it be assumed that the court relied on section 1292(a)(1)? If so, did it utilize the action-at-law route or the functional analysis approach?

A partial answer to this inquiry may be found in an earlier Fourth Circuit opinion: where both legal and equitable claims are asserted, the action should be characterized as equitable, for purposes of the *Enelow-Ettelson* rule, unless the equitable relief sought is "merely incidental" to the legal cause of action.[141] In *Fralin* there is no indication that the prayer for injunctive relief was incidental to the claim for damages. If it is assumed that it was not, the action would be characterized as equitable, and the abstention order would be unappealable under the *Enelow-Ettelson* rule.

This circuit has yet to consider the functional approach to exercising jurisdiction under section 1292(a)(1). Whether it would adopt the *Glen Oaks* rule should it find no other avenue available for reviewing an abstention order, as appears to be the case in *Fralin*, is an open question. It seems unlikely that Mr. Justice Clark would have pursued that course in *Fralin*, for he was a member of the Court when it noted that "it is better judicial practice to follow [*Enelow* and *Ettelson*,] the precedents which limit appealability of interlocutory orders, leaving Congress to make such amendments [to section 1292] as it may find proper."[142]

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[138]385 F.2d 528 (3d Cir. 1967). *See* note 62 *supra*. Had the *Howell* court addressed this matter, it might have reviewed the order by way of a writ of mandamus rather than adopt the *Glen Oaks* rule. *Cf.* Cotler v. Inter-County Orthopaedic Ass'n, 526 F.2d at 541 (Where mandamus relief is available, "[r]eviewing the district court's action pursuant to 28 U.S.C. § 1651 seems preferable to adopting what would for this circuit be a new interpretation of § 1292(a)(1).").

[139]493 F.2d 481, 482 (4th Cir. 1974) (Clark, J.). *See* notes 63-64 *supra* and accompanying text.

[140]28 U.S.C. § 1292(b) (1970). See text accompanying notes 143-72 *infra*.

[141]Chapman v. International Ladies Garment Workers' Local 581, 401 F.2d 626 (4th Cir. 1968).

[142]Baltimore Contractors, Inc. v. Bodinger, 348 U.S. 176, 185 (1955). At the time the Court made this remark and acknowledged that it was "not authorized to approve or declare judicial modification of § 1292," *id.* at 181, a committee designated to consider the matter had already recommended to the Judicial Conference of the United States the bill which was to become 28 U.S.C. § 1292(b). S. REP. No. 2434, 85th

2. Discretionary Appeals Under Section 1292(b)[143]

Congress did amend section 1292 by adopting the Interlocutory Appeals Act of 1958, 28 U.S.C. § 1292(b). This provision, unlike section 1292(a), was cast so that appeal is committed to the discretion of both the district and the appellate court rather than being a matter of right.

> When a district judge, in making in a civil action an order not otherwise appealable under this section, shall be of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation, he shall so state in writing in such order. The Court of Appeals may thereupon, in its discretion, permit an appeal to be taken from such order, if application is made to it within ten days after entry of the order . . . .[144]

To date only the Fifth Circuit has demonstrated a readiness to utilize section 1292(b) for the purpose of reviewing an abstention order. After entering such an order in *Public Employees Local 1279 v. Alabama*,[145] the district judge certified the cause for appeal. Plaintiffs filed a notice of appeal within ten days but failed to petition the appellate court for permission to appeal, a fact which escaped the attention of that court until after oral argument. In dismissing the appeal on its own motion, the court noted that to perfect an appeal from such an unappealable order the prerequisites of section 1292(b) and Rule 5 of the Federal Rules of Appellate Procedure must be met. Failure to file an application for leave to appeal within the statutory

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Cong., 2d Sess. 5, *reprinted in* [1958] U.S. CODE CONG. & AD. NEWS 5259. This bill was subsequently introduced in Congress at the request of the Administrative Office of the United States Courts and adopted without change.

[143]28 U.S.C. § 1292(b) (1970). *See generally* Wright, *The Interlocutory Appeals Act of 1958*, 23 F.R.D. 199 (1959); Note, *Section 1292 (b): Eight Years of Undefined Discretion*, 54 GEO. L.J. 940 (1966); Note, *Interlocutory Appeals in the Federal Courts Under 28 U.S.C. § 1292(b)*, 88 HARV. L. REV. 607 (1975) [hereinafter cited as *Appeals Under § 1292 (b)]; Appealability in the Federal Courts, supra* note 37, at 378-82; Note, *Discretionary Appeals of District Court Interlocutory Orders: A Guided Tour through Section 1292(b) of the Judicial Code*, 69 YALE L.J. 333 (1959) [hereinafter cited as *Discretionary Interlocutory Appeals*]; Note, *Proposals for Interlocutory Appeals*, 58 YALE L.J. 1186 (1949).

[144]28 U.S.C. § 1292(b) (1970).

[145]453 F.2d 922 (5th Cir. 1972). Plaintiffs in *Public Employees* sought a declaratory judgment that an Alabama statute was unconstitutional. The district judge ordered the federal proceedings stayed for a reasonable time to permit exhaustion of state administrative and judicial remedies. After denying plaintiffs' motion for reconsideration, he certified the abstention order for appeal under section 1292(b).

period was held to be a jurisdictional defect.[146] Consideration of the posture of the appeal at the time of its dismissal provides ample evidence, nonetheless, that in 1972 the Fifth Circuit was bent upon reviewing the abstention order under what it perceived to be its section 1292(b) jurisdiction.

No mention was made of whether the order was properly certified for appeal, *i.e.*, whether the order satisfied the statutory criteria for certification. However, by noting that the interlocutory order before it was "non-appealable,"[147] the court implicitly recognized that the first of the four standards had been met. The significance of such a finding is borne out by the Supreme Court's analysis of section 1292: "Section 1292(a) provides for an appeal as a matter of right from a number of specified types of interlocutory orders—in particular, interlocutory orders granting or denying injunctions,"[148] while subsection (b) was "intended to apply *only* to interlocutory orders, 'not otherwise appealable under' § 1292(a)."[149] It follows that one of the essential characteristics of an order from which an appeal will lie under section 1292(b) is its unappealability under subsection (a).

The Fifth Circuit's 1974 holding that an abstention order is appealable under section 1292(a)(1)[150] has cast doubts on whether it would or could now assume jurisdiction of an appeal from such an order under section 1292(b). That circuit's recent shift toward section 1291 as a basis for assuming jurisdiction of an appeal from a stay order[151] may obviate the need for its deciding which of section 1292's mutually exclusive subsections is applicable when it is again confronted with an appeal from an abstention order. The same may not be true of those courts of appeals which have assumed jurisdiction of similar appeals under section 1292(a)(1), but have yet to follow *Druker's* lead.

Resolution of this matter could conceivably be accomplished by holding: (1) that all abstention orders are appealable under section 1292(b), a holding which would require overruling cases relying on the *Glen Oaks* rule, or (2) that abstention orders entered in actions seeking only injunctive relief, including a preliminary injunction, are appealable under the *Glen Oaks* interpretation of section 1292(a)(1), while those entered in declaratory judgment actions or actions at law are appealable under section 1292(b). Should the first alternative be adopted, appeals from all abstention orders would, at least to a

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[146] *Id.* at 924.

[147] *Id.*

[148] Tidewater Oil Co. v. United States, 409 U.S. 151, 167 (1972).

[149] *Id.* at 166 (emphasis in original).

[150] Gray Line Motor Tours, Inc. v. City of New Orleans, 498 F.2d 293, 298 (5th Cir. 1974). *See* text accompanying note 111 *supra.*

[151] Hines v. D'Artois, 531 F.2d 726 (5th Cir. 1976). *See* note 73 *supra.*

certain point, be treated similarly. Adoption of the second approach would result in disparate treatment of appeals and create insurmountable problems when both legal and equitable relief is sought.

Assuming arguendo that the courts of appeals make the necessary accommodation to satisfy the requirement that the order is "not otherwise appealable under this section," the order itself must still satisfy the three remaining criteria set forth in section 1292(b) to be properly certified for appeal.[152] The first of these is that the "order involves a controlling question of law." A Ninth Circuit definition of "controlling question of law"—whether the district judge erred or abused his discretion in staying the proceedings[153]—appears, at first blush, to lend itself to certification of an abstention order. To employ such a definition, however, requires a court to disregard the legislative history of this "judge-sought, judge-made, judge-sponsored enactment."[154] "It is not thought . . . that mere question as to the correctness of the ruling would prompt the granting of the certificate."[155] Moreover, it would, in effect, alter the wording of this provision by substituting "is the" for "involves a."

No definition need be interposed between the standard itself and an abstention order to bring the latter within the purview of the former for a controlling question of state law is central to every case in which the abstention doctrine has been invoked. At the same time it must be recognized that from its inception this doctrine has been linked with the exercise of discretion[156] whereby the federal

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[152]The district judge must certify that the order satisfied these three criteria. Katz v. Carte Blanche Corp., 496 F.2d 747, 755 (3d Cir. 1974). Where that determination entailed consideration of all relevant and no improper factors, it is inappropriate for the court of appeals to reconsider the matter. *Appeals Under § 1292(b), supra* note 143, at 617. However, where the requirements for conferring jurisdiction are not met, an appellate court should not attempt to exercise its jurisdiction under section 1292(b). Hadjipateras v. Pacifica, S.A., 290 F.2d 697, 707 (5th Cir. 1961) (Jones, J., dissenting).

[153]Lear Siegler, Inc. v. Adkins, 330 F.2d 595, 598 (9th Cir. 1964). *See generally Appeals Under § 1292(b), supra* note 143, at 618-24; *Discretionary Interlocutory Appeals, supra* note 143, at 352.

[154]Hadjipateras v. Pacifica, S.A., 290 F.2d 697, 702 (5th Cir. 1961).

[155]S. REP. NO. 2434, 85th Cong., 2d Sess. 6, *reprinted in* [1958] U.S. CODE CONG. & AD. NEWS 5260-61.

[156]Discretion has been referred to as one of the "brightly blooming blossoms on the path of abstention" by virtue of the frequent appearance of the term in opinions discussing that doctrine. Pell, *Abstention—A Primrose Path by Any Other Name*, 21 DE PAUL L. REV. 926, 933 (1971) [hereinafter cited as *Primrose Path*]. It should be noted that the Court has, on occasion, qualified this term, *e.g.*, "wise discretion," Railroad Comm'n v. Pullman Co., 312 U.S. 496, 501 (1941), "fair and well-considered" discretion, Louisiana Power & Light Co. v. City of Thibodaux, 360 U.S. at 30. While "a federal district court is vested with discretion to decline to exercise or to postpone the exercise of its jurisdiction in deference to state court resolution of underlying issues of state law," Harman v. Forssenius, 380 U.S. 528, 534 (1965), it is not to automatically apply the abstention doctrine when confronted by an issue of state law as to which there is some doubt. Baggett v. Bullitt, 377 U.S. 360, 375 (1964).

courts "restrain their authority because of 'scrupulous regard for the rightful independence of the state governments' and for the smooth working of the federal judiciary."[157] Courts analyzing the use of the term "law" have concluded that a law/fact distinction was implied and for that reason had held that matters committed to the discretion of the district court are immune from review under section 1292(b) since they present mixed questions of law and fact.[158] Adopting this position would preclude appellate review of abstention orders under this provision.

Inherent in the Ninth Circuit's approach to determining whether an order was properly certified is a second flaw. By equating the trial court's ruling with the requisite "controlling question of law," this court arrives at essentially the same point as the writer who describes the second of the remaining statutory criteria as the "requirement that there be a substantial ground for difference of opinion about the *challenged order.*"[159] The plain language of the jurisdictional statute makes it clear that the *controlling question of law* is the focal point of this standard, not the order itself.

An abstention order is, in essence, an acknowledgement by the district court that there is "a controlling question of state law as to which there is substantial ground for difference of opinion." Unlike certification of the order under section 1292(b), the abstention order itself operates as an informal and indirect means of certifying a doubtful state law question to the highest court of that state[160]—"the only tribunal whose interpretation could be controlling."[161] In this regard it can be said that an abstention order is designed to achieve the same objective as a section 1292(b) appeal, but by different means

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[157]Railroad Comm'n v. Pullman Co., 312 U.S. at 501.

[158]*Appeals Under § 1292(b), supra* note 143, at 618 n.57. *But see* Katz v. Carte Blanche Corp., 496 F.2d 747, 755-57 (3d Cir. 1974) (orders committed to the district court's discretion are subject to review under section 1292(b) where the district judge considered improper factors or failed to consider all those relevant to his decision).

[159]*Compare Appeals Under § 1292(b), supra* note 143, at 624, *with* Lear Siegler, Inc. v. Adkins, 330 F.2d 595, 598 (9th Cir. 1964) ("[T]he district judge was correct in his opinion that the question of law [— whether the district judge erred in staying the proceedings—] is one 'as to which there is substantial ground for difference of opinion.' "). *Accord,* Katz v. Carte Blanche Corp., 496 F.2d 747, 754 (3d Cir. 1974).

[160]Certification procedures are available in several states either by statute or court rule. *See generally* Lehman Bros. v. Schein, 416 U.S. 386, 390-91 nn.7 & 8 (1974); *Primrose Path, supra* note 156, at 946-47; Lillich & Mundy, *Federal Court Certification of Doubtful State Law Questions,* 18 U.C.L.A.L. REV. 888 (1971). Indiana has adopted a variation of the Uniform Certification of Questions of Law Act. Unlike the Uniform Act, the Indiana statute precludes certification by the United States district courts. *Compare* Uniform Certification of Questions of Law Act, *reprinted in* 18 U.C.L.A.L. REV., *supra* at 913-15 app. *with* IND. CODE § 33-2-4-1 (Burns 1975).

[161]Louisiana Power & Light Co. v. City of Thibodaux, 360 U.S. at 30.

and for different reasons.[162] The report of the Senate Committee on the Judiciary bears this out. "[T]he appeal from interlocutory orders thus provided should and will be used only in exceptional cases . . . where a question which would be dispositive of the litigation is raised and there is serious doubt as to how it should be decided . . . ."[163]

Because matters in the district court's discretion are seldom reversed on appeal and thus seldom "materially advance the ultimate termination of the litigation," they are not thought to be subject to review under section 1292(b).[164] The same result should obtain with regard to abstention orders notwithstanding the fact that reversal is not uncommon; in most instances all that is determined on appeal is the forum in which the state law issue is to be resolved—a decision which appears to fall short of satisfying the last of the statutory criteria for certification.

The not infrequent reversal of abstention orders on appeal stems from the circuits' application of a standard for evaluating the district court's action which does not comport with that ordinarily used, that is, a trial court's exercise of discretion may be set aside only if it is arbitrary or where no reasonable man would adopt the lower court's position.[165] Not all are in agreement that such a distinction should be made.

> To the extent that determination of the correctness of abstention or nonabstention is truly a matter of discretion rather than a mechanical application of judicially established rules of thumb, some of which apparently have come along after the act . . . the ordinary rules pertaining to evaluation of discretionary action should apply.[166]

Appellate courts have generally recognized that district courts exercise a broad range of discretion in ruling on motions for a stay of proceedings pending litigation in another tribunal.[167] This is not the case where abstention is involved. Some blatantly admit having

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[162]It has been suggested that by adopting section 1292(b) Congress sought to provide a means by which unnecessary district court proceedings could be avoided. *Appeals Under § 1292(b), supra* note 143, at 609, 611. Neither alleviation of hardship to litigants nor appellate supervision of district courts was thought to justify appeal under this section. *Id.* at 609, 612 & n.28, 631.

[163]S. REP. No. 2434, 85th Cong., 2d Sess. 6, *reprinted in* [1958] U.S. CODE CONG. & AD. NEWS 5260.

[164]*Appeals Under § 1292(b), supra* note 143, at 618 n.57.

[165]Particle Data Laboratories, Inc. v. Coulter Electronics, Inc., 420 F.2d 1174, 1178 (7th Cir. 1969).

[166]*Primrose Path, supra* note 156, at 934. Judge Pell sits on the United States Court of Appeals for the Seventh Circuit.

[167]Gray Line Motor Tours, Inc. v. City of New Orleans, 498 F.2d at 298.

made "inroads on the freedom of the district courts to refer the parties to another forum."[168] The First Circuit's comment in *Druker* that it saw "no substitute for a close analysis of the challenged state law" clearly indicates the extent of those inroads.[169] Indeed, a reading of the cases leads one to believe that in almost every instance there has been a de novo review of the matter by the court of appeals.[170] If supervision of the district courts is not a justification for a section 1292(b) appeal, as one writer concludes,[171] certification of an abstention order under that provision would appear to be improper, notwithstanding an appellate court's desire to consider and decide the question for itself.[172]

C. Section 1253—Direct Appeals from Decisions of Three-Judge Courts

Unlike the preceding sections of the Judicial Code, which contemplate an appeal from a district court order to an intermediate appellate court, section 1253 confers on the Supreme Court jurisdiction of a direct appeal "from an order granting or denying, after notice and hearing, an interlocutory or permanent injunction in any civil action, suit or proceeding required by any Act of Congress to be heard and determined by a district court of three judges."[173]

On a number of occasions the Supreme Court has exercised its jurisdiction over an appeal from an abstention order entered by a three-judge court notwithstanding the fact that the order neither granted nor denied injunctive relief.[174] With but one exception the Court failed to address the question of its jurisdiction;[175] in none did it

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[168]*Id.*

[169]Druker v. Sullivan, 458 F.2d at 1274.

[170]*Primrose Path, supra* note 156, at 934.

[171]*Appeals Under § 1292(b), supra* note 143, at 608, 612 & n.28, 631.

[172]"The desirability of deciding a question is not one of the jurisdictional tests [under section 1292(b)]." Hadjipateras v. Pacifica, S.A., 290 F.2d at 707 (Jones, J., dissenting).

[173]28 U.S.C. § 1253 (1970).

[174]Daniel v. Waters, 417 U.S. 963 (1974) (vacated abstention order); Koehler v. Ogilvie, 405 U.S. 906 (1972) (affirmed abstention order); Sweet Briar Institute v. Button, 387 U.S. 423 (1967) (reversed abstention order); Turner v. City of Memphis, 369 U.S. 350 (1962) (vacated abstention order); NAACP v. Bennett, 360 U.S. 471 (1959) (vacated abstention order); Bryan v. Austin, 354 U.S. 933 (1957) (vacated abstention order where cause had become moot); Government & Civic Employees Organizing Comm. v. Windsor, 347 U.S. 901 (1954) (affirmed abstention order).

[175]The Court postponed consideration of the question of its jurisdiction under section 1253 until the hearing on the merits at which time it concluded that a three-judge court was not required; thus jurisdiction of the appeal was vested in the Sixth Circuit. Because appellant had perfected an appeal to that court, the Supreme Court assumed jurisdiction of the appeal pursuant to 28 U.S.C. §§ 1254(1), 2101(e) by treating his jurisdictional statement as a petition for writ of certiorari prior to judgment in the

note probable jurisdiction under section 1253. This practice did not go unnoticed by the courts or the commentators and contributed significantly to the assumption that abstention orders entered by three-judge courts were appealable under section 1253, while those entered by a single district judge were appealable under section 1292(a)(1).[176]

Although there were signs as early as 1974 that abstention orders were no longer directly appealable to the Supreme Court,[177] this matter was not definitively settled until a year later when the Court handed down its decision in *MTM, Inc. v. Baxley.*[178] In *MTM* the Court held that it is without jurisdiction to consider an appeal under section 1253 where an order of a three-judge court, such as an abstention order, does not rest upon resolution of the merits of the constitutional claim.[179]

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court of appeals. Turner v. City of Memphis, 369 U.S. 350 (1962). This approach presupposes that the Sixth Circuit would have had jurisdiction of the appeal in the first place. The Court's opinion in *Turner* is silent as to the means by which appellant-petitioner might have invoked the jurisdiction of that court had it not summarily disposed of the appeal.

[176]To provide support for the proposition that the order appealed from in *Idlewild* was "of the sort ordinarily appealable" note was made of the fact that the Court considered the merits in NAACP v. Bennett, 360 U.S. 471 (1959), without discussing the abstention order's appealability. Idlewild Bon Voyage Liquor Corp. v. Rohan, 289 F.2d at 430 n.1 (dissenting opinion).

The Court's action in Bryan v. Austin, 354 U.S. 933 (1957), prompted the following comment:

> Although the appeal in *Bryan* arose under section 1253, the Court's disregard for the technical arrangement of claims should be equally applicable to section 1292(a)(1). Both sections are similar, for they both permit appellate review of orders granting or denying interlocutory injunctions. Logically, the same result as to the appealability of stay orders should be reached under both statutes.

Note, *Appealability of Stay Orders in the Federal Courts*, 47 MINN. L. REV. 1099, 1106-07 (1963).

[177]*See* Daniel v. Waters, 417 U.S. 963 (1974); text accompanying notes 30-35 *supra*. *Daniel* appears to be the first case in which the Supreme Court declined to exercise its jurisdiction over a direct appeal from an abstention order entered by a three-judge court. Daniel v. Waters, 515 F.2d 485, 493 n.1 (6th Cir. 1975) (dissenting opinion). The dissent noted that the order fell short of adjudicating the constitutional merits of the challenged statute and neither granted nor denied injunctive relief. *Id.* at 493. The majority interpreted the Court's order as an indication that its section 1253 jurisdiction was not properly invoked. This followed from its conclusion that the challenged statute was patently unconstitutional, therefore, a three-judge court was not required. *Id.* at 492.

[178]420 U.S. 799 (1975). *MTM* has been cited as authority for the proposition that where a three-judge court does not base its order of abstention on "resolution of the merits of the constitutional claims," appeal lies to the court of appeals rather than the Supreme Court. Sea Ranch Ass'n v. California Coastal Zone Conservation Comm'ns, 537 F.2d 1058, 1061 (9th Cir. 1976); Daniel v. Waters, 515 F.2d at 493 n.1* (dissenting opinion).

[179]420 U.S. at 803-04.

III. Idlewild Revised

In *Gonzalez v. Automatic Employees Credit Union* the Supreme Court acknowledged that it had "to retrace its steps" in *Idlewild* to hold, as it did, that review of a single judge's refusal to convene a three-judge court may be had in the court of appeals and not in the Supreme Court.[180] The Court did not similarly apprise the reader of its retracing its steps in *Gonzalez*. However, the statement made therein regarding the modes by which that jurisdiction may be exercised stands in sharp contrast to that made twelve years earlier in *Idlewild*.

> Where a single judge refuses to request the convention of a three-judge court, but retains jurisdiction, review of his refusal may be had in the court of appeals, see *Idlewild* [and *Schackman v. Arnebergh*], either through petition for writ of mandamus or through a certified interlocutory appeal under 28 U.S.C. § 1292(b).[181]

> The Court of Appeals properly rejected the argument that the order of the District Court [refusing to convene a three-judge court but retaining jurisdiction] "was not final and hence unappealable under 28 U.S.C. §§ 1291, 1292," pointing out that "[a]ppellant was effectively out of court."[182]

Implicit in the Court's latest pronouncement is its recognition that the order entered in *Idlewild* "'was not final and hence unappealable under 28 U.S.C. §§ 1291, 1292[(a)(1)].' " Thus, courts and commentators can no longer cite that case as authority for the proposition that abstention orders are appealable as of right under either or both of these provisions. Furthermore, nothing in the *Gonzalez* dictum suggests that that portion of the order directing abstention comes within the appellate court's scope of review under section 1292(b) or section 1651. The Court's repeated failure to comment on the appealability of that portion of the order served to reinforce the conclusion that a single district judge lacked jurisdiction to abstain when a three-judge court was requested and the criteria for convening such a court were satisfied.[183]

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[180]419 U.S. 90, 95 & n.13, 100 n.19 (1974).

[181]*Id.* at 100 n.19.

[182]Idlewild Bon Voyage Liquor Corp. v. Epstein, 370 U.S. at 715 n.2.

[183]*See* Apel v. Murphy, 526 F.2d 71, 73 (1st Cir. 1975); Idlewild Bon Voyage Liquor Corp. v. Rohan, 289 F.2d at 429. Because the existence of such jurisdiction turned upon the propriety of the refusal to convene a three-judge court pursuant to 28 U.S.C. §§ 2281 and 2284, it would have been unnecessary for the court of appeals to consider the appropriateness of abstention should it reverse for the convening of such a court. Should the lower court's decision on this matter have been affirmed, however, it would seem improper for the appellate court to have taken one step further in the case, that is, to consider whether the issue of state law warranted abstention. *Gonzalez* provides no support for a contrary conclusion.

With the repeal in 1976 of 28 U.S.C. § 2281 the requirement for convening a three-judge court in cases seeking to enjoin the enforcement of a state statute on the ground that it is unconstitutional has been eliminated, except in reapportionment cases.[184] From this it follows that a single district judge is no longer without jurisdiction to abstain where application of the *Pullman* abstention doctrine is appropriate.

IV. Conclusion

The Supreme Court's holding in *MTM* made it clear that abstention orders are not directly appealable to that court under section 1253. Their appealability to the circuit courts of appeals, however, remains unsettled. Although an abstention order does not finally deny relief in federal court, is not, in most instances, tantamount to a denial of a preliminary injunction, and does not satisfy the requisities for a certified interlocutory appeal, an appeal from such an order has yet to be dismissed for want of jurisdiction. Nonetheless, review of such orders by way of appeal appears to constitute a usurpation of jurisdiction which is not given.[185] Furthermore, "[s]uch review is ordinarily undesirable. A principal reason for the delays experienced under existing abstention practices has been that parties have years of litigation merely to determine in which court the case will be litigated."[186] In any event, when application of the doctrine constitutes an abuse of discretion, appellate relief from the abstention order should be available under the All Writs Act.[187]

In light of the fact that *Idlewild* no longer provides *any* authority for assuming jurisdiction under sections 1291 or 1292(a)(1), the courts of appeals may not be as reluctant to question their jurisdiction over such appeals in the future. Those finding none may even

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[184]Act of Aug. 12, 1976, Pub. L. No. 94-381, § 1, 90 Stat. 1119 (1976). *See* S. Rep. No. 94-204, *supra* note 14, for the legislative history of this enactment.

[185]*But see* Daniel v. Waters, 417 U.S. at 963. In *Daniel* the Court vacated the district court's abstention order and remanded the case for the entry of "a fresh judgment from which a timely appeal may be taken to the Court of Appeals," notwithstanding appellants' having timely filed a protective appeal with the Sixth Circuit. Is the proper interpretation of the Court's order that "no three-judge District Court was necessary," Daniel v. Waters, 515 F.2d at 492, "that [the Sixth Circuit], rather than the Supreme Court, should review the merits of the three-judge District Court's abstention order," *id.* at 493 (dissenting opinion), or that an appealable order—a denial of the preliminary injunction which was sought, an interlocutory order certified for appeal under section 1292(b), or a dismissal of the action—should be entered by the district court upon remand?

[186]ALI Study, *supra* note 12, at 291.

[187]28 U.S.C. § 1651 (1970). *See generally Supervisory and Advisory Mandamus*, *supra* note 16.

acknowledge that "whether the local-law problem counseled abstention" is a question properly left to those most familiar with that law—the district judges.[188] "They know about *Pullman* [and its progeny] as well as most of [those on the Supreme Court]. It was a new doctrine when announced. It is word that has long been part of the warp and woof of federal law."[189]

JOAN GODLOVE

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[188]Harris County Comm'rs Court v. Moore, 420 U.S. 77, 91 (1975) (Douglas, J., dissenting). Mr. Justice Douglas' comment, although made by way of dissent to a holding that the district court should have abstained, should be equally applicable to most cases in which abstention is ordered.

[189]*Id.*

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